1988

The Classical Corporation in American Legal Thought

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I. INTRODUCTION: THE CORPORATION IN CLASSICAL POLITICAL ECONOMY

A. MERCANTILISM AND CLASSICAL CORPORATE THEORY

Classical political economy in the United States was dedicated to the principle that the state could best encourage economic development by leaving entrepreneurs alone, free of regulation and subsidy.[1] The classicists believed capital would flow naturally toward investments that promised profit, provided that the channels were clear. In the words of Chief Justice Appleton of the Maine Supreme Court: "Capital naturally gravitates to the best investment. If a particular place or a special kind of manufacture promises large returns, the capitalist will be little likely to hesitate in selecting the place and in determining upon the manufacture."[2] According to classical theory, unprofitable investments were not worth undertaking and a public subsidy

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1. *See* Hovenkamp, *The Political Economy of Substantive Due Process*, 40 STAN. L. REV. 379, 402-04 (1988) (discussion of Adam Smith's influence on U.S. political economy) [hereinafter Hovenkamp, *Political Economy*]. By "subsidy," I mean an explicit payment of cash or other property by the state to a business enterprise, not merely the adoption of liability-reducing common law rules that might lower the relative costs of economic development. *See* M. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1780-1860, at 63-108 (1977) (describing creation of 19th century common law doctrines that provided de facto subsidies for economic development); Hovenkamp, *The Economics of Legal History*, 67 MINN. L. REV. 645, 670-680 (1983) (defending Horwitz's depiction of liability-reducing common law changes in 19th century as a subsidy, although different from taxation and transfers).

2. Opinion of the Justices, 58 Me. 590, 592 (1871).

would not make them so. From the 1830s until the end of the nineteenth century, classical political economy dominated state economic policy, although neither legislators nor judges followed the classical model with complete consistency. For example, both state and federal governments encouraged railroad development with an array of subsidies that courts generally approved.[3]

The development of classical economic policy in the United States dramatically changed the concept of the business corporation. Within the preclassical, mercantilist model, the corporation was a unique entity created by the state for a special purpose and enjoying a privileged relationship with the sovereign.[4] The very act of incorporation presumed state involvement. State subsidy and the incorporators' public obligation were natural corollaries. Business firms that relied on the market alone to determine their prospects were simply not incorporated.

As classical theory replaced the mercantilist model, the business corporation gradually evolved into a device for assembling large amounts of capital in a manner that could be controlled efficiently by a small number of managers. Other mechanisms, such as the limited partnership, might have served the same purpose, but in the 1830s and 1840s limited partnerships were relatively unknown while corporations had already had a long history. For example, in 1832 Angell and Ames, the authors of the first American treatise on business corporations, noted only that limited partnerships had existed in France since the late seventeenth century and that Louisiana and New York had authorized them by statute.[5] But "even this kind of partnership lacks the properties that distingnish a corporation," they concluded, "though it comes perhaps nearer to it, than any other association of persons, not established by an incorporating act."[6]

Angell and Ames and others suggested some of the disadvantages of the limited partnership. While the limited partners had limited liability, the ac-

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3. *See* C. GOODRICH, GOVERNMENT PROMOTION OF AMERICAN CANALS AND RAILROADS: 1800-1900 (1960) (analyzing federal, state, and local railroad development subsidies); L. MERCER, RAILROADS AND LAND GRANT POLICY: A STUDY IN GOVERNMENT INTERVENTION 3-4 (1982) (describing federal land grants to railroads); M. SUMMERS, RAILROADS, RECONSTRUCTION, AND THE GOSPEL OF PROSPERITY: AID UNDER THE RADICAL REPUBLICANS, 1865-1877 (analyzing use of railroad development subsidies in Reconstruction South) (1984); Hovenkamp, *Regulatory Conflict in the Gilded Age: Federalism and the Railroad Problem*, 97 YALE L.J. 1017 (1988).

4. *E.g.*, J. CHITTY, JR., A TREATISE ON THE LAW OF THE PREROGATIVES OF THE CROWN 120-33 (1820) (describing formation and characteristics of early 19th century corporations in Great Britain).

5. J. ANGELL & S. AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 24 (Boston 1832). The authors had believed that Pennsylvania had also passed a limited partnership statute, but later admitted they were in error. *Id.* at 372 n.1.

6. *Id.* at 24.

tive partners did not.[7] In fact, since the limited partnership was unknown to the common law, states continued to apply the common law rule holding all partners personally liable for all of the partnership's debts unless a statute authorized reduced liability for limited partners.[8] A second disadvantage was that since limited partnerships did not have a charter, they did not receive federal contract clause protection from subsequent regulation of their activities.[9]

Nevertheless, Angell and Ames described one major advantage of the limited partnership that would encourage firms to use it. Those seeking to raise capital in this way did not need to obtain an act of special incorporation from the state legislature. The New York statute, for example, required only that partners register the limited partnership with the county clerk.[10] The early limited partnership statutes were thus ancestors of the mid-nineteenth century general corporation acts. A first step in the formation of the classical corporation, the limited partnership was a mechanism for achieving lower-risk investment by silent investors in business enterprises that received no special treatment from the state other than limited liability itself.[11]

The classical theory of the corporation began to emerge early in the post-Federalist Supreme Court. It appeared in Chief Justice Taney's holding in *Charles River Bridge v. Warren Bridge*[12] that a monopoly privilege would not be implied in a bridge charter, for "in grants by the public, nothing passes by implication."[13] Although states could not renege on explicit promises, classical theory required that chartered corporations not be presumed to have any special "market privileges" not accorded to others.

One of the most difficult problems classical policymakers faced was extricating the states from previous commitments to private incorporators—which classical economic and legal theorists loathed—while preserving the sanctity of property and contract, which the theory considered all important.

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7. *Id.* at 372.

8. *See, e.g.*, Hess v. Werts, 4 Serg. & Rawle 356, 364-66 (Pa. 1818) (disallowing limited partnerships at common law); Lachomette v. Thomas, 5 Rob. 172, 173 (La. 1843) (partner *in commendam* must register contract creating limited partnership or lose limited liability); Andrews v. Schott, 10 Pa. 47, 51 (1848) (partnership is general unless formed in substantial compliance with limited partnership statute); Richardson v. Hogg, 38 Pa. 153, 155-56 (1861) (partnership not limited unless formed in strict compliance with limited partnership statute); Pierce v. Bryant, 87 Mass. (5 Allen) 91, 93-94 (1862) (partnership is general unless in compliance with limited partnership statute).

9. *See infra* Part II-A (discussing historical development of contract clause protection).

10. J. ANGELL & S. AMES, *supra* note 5, at 24 n.1; *see* 3 J. KENT, COMMENTARIES ON AMERICAN LAW 35 (4th ed. 1840) (limited partnerships must only be registered with county clerk).

11. On the early history of limited partnerships in New York, see R. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855 at 97-98 (1982).

12. 36 U.S. (11 Pet.) 420 (1837). This case was decided one year after President Jackson appointed Chief Justice Taney to the Court.

13. *Id.* at 546.

Eventually, laissez-faire prevailed over property and contract, and the result was the emasculation of the Marshall Court contract clause.

The classical model of the corporation did not emerge mature in a single decision. It evolved gradually in the nineteenth century, reaching its apogee in the 1880s and 1890s. Then it began to fall apart, a victim of its own success. The developing model of the classical corporation included two fundamental premises: (1) the corporate form is not a special privilege but merely one of many ways of organizing a business firm; and (2) the peculiar advantage of the corporation which the law should encourage is its ability to raise and concentrate capital more efficiently than other forms of business organization.

These important developments formed the core of the classical corporate model:

(1) the attack on the Marshall era contract clause;

(2) the demise of the charter theory of business regulation;

(3) the rise of the General Corporation Act and the decline of the special subsidy;

(4) the application of the fourteenth amendment's protections to corporations;

(5) the expansion of limited shareholder liability;

(6) the narrowing scope of quo warranto and ultra vires;

(7) the facilitation of multistate corporate business activities; and

(8) the separation of ownership and control.

All of these developments were natural consequences of classical corporate theory. Inevitably, however, some of the developments themselves undermined the theory, leading to the creation of a post-classical, more regulatory view of the relationship between the state and the corporation.

B. THE CLASSICAL CORPORATE PERSONALITY

Under the classical model of political economy, the ideal law of business corporations would encourage competition by giving the corporation the same legal rights as other forms of business enterprise while giving corporate management any advantage perceived to be inherent in the corporate structure. The most obvious of these advantages was the corporation's ability to raise and mobilize large amounts of capital. The development of classical corporate law necessitated a radical change in the basic idea of the corporation itself. When this change began to occur, it sparked a century-long debate about the legal nature of the corporation. To collapse a very long history, the jurisprudential concept of the corporation passed through three broad categories: (1) an "associational" view, which dominated the Marshall Court's thinking; (2) a "fictional" view, which ascended during the Taney period and dominated most of the nineteenth century;[14] and (3) a "personal" or "entity" view, which became important near the end of the century when the classical theory of the corporation began to collapse.[15]

The associational view is clearly recognized in Chief Justice Marshall's holding in *Bank of the United States v. Deveaux*[16] that a corporation is "certainly not a citizen" under the Constitution.[17] As a result, diversity of citizenship for federal jurisdictional purposes was the citizenship of the corporation's shareholders rather than the state of incorporation or the corporation's principal place of business. Since shareholders might be citizens of more than one state, this view tended to prevent federal suits by or against corporations by reducing the number of situations in which complete diversity between all plaintiffs and all defendants could be found.

The associational view of corporate citizenship dominated the Marshall period until *Deveaux* was overruled by the Taney Court in *Louisville, Cincinnati & Charleston Railroad v. Letson.*[18] *Letson* held that a corporation should be "deemed . . . a person, although an artificial person," and "an inhabitant of the same state, for the purposes of its incorporation, capable of being treated as a citizen of that state, as much as a natural person."[19] The Court conceded that "in some particulars [a corporation] differs from a natural person," but in "the manner in which it can sue and be sued, it is substantially, within the meaning of the law, a citizen of the state which created it."[20]

A decade later, while retaining this position, the Taney Court changed its rationale, admitting that a corporation could not literally be a constitutional "citizen," but creating a conclusive presumption that all shareholders were citizens of the state of incorporation.[21] This proposition was widely criticized as the purest legal fiction.[22] Nevertheless, it remains good law,[23] even

14. *See, e.g.,* J.C. GRAY, THE NATURE AND SOURCES OF THE LAW 49-55 (2d ed. 1924) (describing fictional theory of corporations); Pollock, *Has the Common Law Received the Fiction Theory of Corporations?* 27 L.Q. REV. 219 (1911) (arguing that fictional theory never wholly accepted by English courts in 19th century).

15. For a discussion of the development of the law in England and continental Europe, see F. HALLIS, CORPORATE PERSONALITY at xxxviii-lxiii (1930).

16. 9 U.S. (5 Cranch) 61 (1809); *see* G. HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 54-57 (1918) (commenting on *Deveaux*).

17. 9 U.S. (5 Cranch) at 86.

18. 43 U.S. (2 How.) 497 (1844).

19. *Id.* at 558.

20. *Id.* at 557.

21. Marshall v. Baltimore & O.R.R., 57 U.S. (16 How.) 314, 328-29 (1853).

22. Justice Daniel wrote a stinging dissent, *id.* at 338-47, and Justice Campbell noted in his dissent that the question whether a corporation was a "person" was quite different from the question whether the corporation was a "citizen" under the constitution:

> A corporation is not a citizen. It may be an artificial person, a moral person, a juridical person, a legal entity, a faculty, an intangible, invisible being; but Chief Justice Marshall

though its logic was undermined two years later by *Dodge v. Woolsey*,[24] which entertained a diversity action between a shareholder and a corporation.

The associational view also appeared in the question of entitlement to sue for injuries to the corporation or to collect its debts. The associational view suggested that injuries to the corporation were injuries to its shareholders who alone should have the cause of action. In fact, Angell and Ames' 1832 treatise discussed whether the corporation was *permitted* to be a party in certain legal proceedings.[25] They cited the traditional English rule that the corporation itself could not be sued for its torts but that such an "action must be brought against each person who committed the tort by name."[26] Only in 1812 did an English court sustain an action in trover against a corporation.[27] However, American courts, utilizing agency principles, already had begun permitting tort and other actions by and against the corporation itself.[28]

The issue was controversial as late as 1827, provoking a lengthy debate between Justice Story and Chief Justice Marshall in *Bank of the United States v. Dandridge*.[29] The Court, speaking through Justice Story, permitted an action by the bank on a performance bond respecting one of its cashiers.[30] The directors had individually approved the bond, but it had not been officially delivered and accepted by the corporation and placed under its seal. In a long dissent, Chief Justice Marshall complained that the corporation could act only within the scope of its charter: any inconsistent action was that of its individual directors and not of the corporation itself.[31] As a result, the Bank should not be entitled to sue on the bond. "The voice which utters" in

> employed no metaphysical refinement, nor subtlety, nor sophism, but spoke the common sense, "the universal understanding," as he calls it, of the people, when he declared the unanimous judgment of this court, "that it certainly is not a citizen."

Id. at 351.

23. *See* C.A. WRIGHT, LAW OF FEDERAL COURTS 149 (4th ed. 1983) (presumption of stockholder's citizenship in state of incorporation remains settled law).

24. 59 U.S. (18 How.) 331 (1855).

25. J. ANGELL & S. AMES, *supra* note 5, at 209-210.

26. *Id.* at 220.

27. Yarborough v. Bank of England, 104 Eng. Rep. 991 (1812).

28. J. ANGELL & S. AMES, *supra* note 5, at 221; *see* Hayden v. Middlesex Turnpike Corp., 10 Mass. 397, 400-03 (1813) (permitting suit for services against corporation); Minot v. Curtis, 7 Mass. 441, 444 (1811) (permitting suit against incorporated church in name of individuals who comprised it); Berks v. Dauphin Tpke. Rd., 6 Serg. & Rawle 12, 16-17 (Pa. 1820) (permitting suit on debt to corporation by "President, Managers and Company"); *Corporations*, 4 AM. JURIST & L. MAG. 298, 302-03 (1830) (describing gradual acceptance of corporate liability in United States during 1820s); 2 J. KENT, COMMENTARIES ON AMERICAN LAW 235 (1827) ("[i]t is a general rule, that corporations must take and grant, as well as sue and be sued, by their corporate name").

29. 25 U.S. (12 Wheat.) 64 (1827).

30. *Id.* at 64-65, 90.

31. *Id.* at 91-92 (Marshall, C.J., dissenting).

the name of the corporation, Marshall concluded, "must be the aggregate voice.... The words they utter are the words of individuals. These individuals must speak collectively to speak corporately, and must use a collective voice."[32] Implicit in Marshall's reasoning was that the individual actors of the corporation, rather than the corporation itself, were responsible for acts not strictly authorized by or in conformity with the corporate charter. Carried to its conclusion, this suggested that the corporation's agents, not the corporation itself, were answerable for damages caused by ultra vires acts, since such acts were never authorized by the charter.

By the time Angell and Ames published their treatise, however, Marshall's associational view was already widely rejected.[33] In fact, the ancient doctrine was being stood on its head. Courts began holding that shareholders ordinarily lacked standing to sue for injuries to the corporation and that suits by outsiders for injury caused by the corporation must be brought against the corporation itself.[34] At the same time, the expansion of limited shareholders' liability effectively insulated shareholders from most tort and contract claims against the corporation. Within a generation the rule that a shareholder was not a proper party to litigation against the corporation was essentially absolute.[35]

Shareholder disqualification from direct participation in the classical corporation's legal affairs began the gradual separation of corporate ownership from its control, a process whose importance was not generally recognized until the 1920s and 1930s.[36] The shareholders' derivative suit alleging viola-

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32. *Id.* at 92.

33. *See Corporations*, *supra* note 28, at 302-303 (noting Marshall's admission that his view of corporate identity was generally condemned). Early decisions include Portsmouth Livery Co. v. Watson, 10 Mass. 91 (1813) (denying defendant's plea in abatement that action brought against corporation should have been brought against the shareholders); Hayden v. Middlesex Tpke. Corp., 10 Mass. 397, 400-01 (1813) (assumpsit can be brought against corporation itself); Chestnut Hill & Spring House Tpke. Co. v. Rutter, 4 Serg. & Rawle 6, 14-19 (Pa. 1818) (allowing corporate liability in tort suit).

34. *E.g.*, Spear v. Grant, 16 Mass. 9, 12 (1819) (disallowing suit against stockholders for debts against the corporation); Ogdensburgh Bank v. Van Rensselaer, 6 Hill 240 (N.Y. 1843) (disallowing suit against individual officers of corporation); Verplanck v. Mercantile Ins. Co., 2 Paige Ch. 438, 449-50 (N.Y. Ch. 1831) (complaint naming officers of corporation disallowed in suit against corporation); *see also* Bronson v. La Crosse & Mil. R.R., 69 U.S. (2 Wall.) 283, 301-03 (1863) (shareholders not entitled to answer lawsuit filed against corporation).

35. *See* J. ANGELL & S. AMES, *supra* note 5, at 376-409 (examining process of suits against corporations and noting that shareholders had no responsibility at common law for corporate debt).

36. *See infra* text accompanying notes 566-76. This separation is exemplified by an 1847 Supreme Judicial Court of Massachusetts decision that denied a shareholder's suit for injuries suffered by a bank. Corporation shares, the court stated, represent:

> a limited and qualified right which the stockholder has to participate, in a certain proportion, in the benefits of a common fund .... To the extent of [any] separate and peculiar interest, a stockholder, no doubt, might maintain his separate and special action . . . as trover or trespass, for the conversion or tortious taking of his certificate.... But an injury

tion of the director's legal duty to bring or defend claims came to prominence in mid-nineteenth century as the shareholders' only legal interest in the corporation's legal affairs.[37] This effectively segregated the corporation's legal claims from those of its shareholders.

II. THE DECLINE OF VESTED RIGHTS: CORPORATE THEORY AND THE ATTACK ON THE MARSHALL ERA CONTRACT CLAUSE

A. INTRODUCTION

1. Vested and Substantive Rights

With the ratification of the fourteenth amendment, the due process clause became the primary source of constitutional protection of individual liberties against state and local governments. The greatest contribution of classical political economy to constitutional jurisprudence during the late nineteenth century was substantive due process, which effectively constitutionalized classical political economy's abhorrence of state interference with the market.[38] At the same time, the contract clause, the principal source of protection in the antebellum period, became gradually less important. By the end of the century, the contract clause was a withered skeleton of its Marshall era frame.[39]

In the nineteenth century, federal courts used both the contract clause and the fourteenth amendment due process clause to secure "economic" liberties. These liberties included the right to rely on previously executed grants or contracts and eventually the right to *make* a contract to engage in a lawful activity. The thrust of Marshall era contract clause jurisprudence was that once a right had "vested," either by private bargaining or an arrangement with the sovereign, the sovereign could not take away or alter that right. However, the sovereign might alter the remedy, provided that the change did not completely undermine enforcement of the right.[40] For example,

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> done to the stock and capital, by negligence or misfeasance, is not an injury to such separate interest, but to the whole body of stockholders in common. It is like the case of a common nuisance, where one who suffers a special damage, peculiar to himself, and distinguishable in kind from that which he shares in the common injury, may maintain a special action. Otherwise he cannot.

Smith v. Hurd, 53 Mass (12 Met.) 371, 386 (1847).

37. *See* Dodge v. Woolsey, 59 U.S. (18 How.) 331, 342-44 (1855) (shareholder has cause of action in equity when corporation breaches trust).

38. *See* Hovenkamp, *Political Economy, supra* note 1 at 394-98 (discussion of the economic fourteenth amendment).

39. *See* Kainen, *Nineteenth Century Interpretations of the Federal Contract Clause: the Transformation from Vested to Substantive Rights Against the State,* 31 BUFFALO L. REV. 381, 383-87 (1982) (summarizing prominent Marshall Court contract clause cases and their subsequent reversal in latter half of nineteenth century).

40. *See* Green v. Biddle, 21 U.S. (8 Wheat.) 1, 17 (1823) ("It is no answer, that the acts . . . now

although the sovereign could not give debtors broad retroactive relief from debts,[41] it could deny creditors the right to have debtors sent to debtors' prison.[42] The sovereign could also impose statutes of limitation on the right of recovery.[43] Importantly, the Constitution did not define the content of these rights; they were determined by a freely negotiated agreement. The Constitution was interpreted only to prevent states from substantially undermining these rights once they were determined and had vested.

Under the doctrine of substantive due process, the Constitution itself created rights against the sovereign, such as the right to engage in a lawful occupation or to bargain freely for the terms of one's employment. Although these rights are often characterized by the term "liberty of contract,"[44] they were fundamentally different from the rights secured by the contract clause. They involved the liberty *to* contract—i.e., to enter *prospective* agreements—rather than the sanctity of preexisting contracts. Contract clause jurisprudence focused on whether the rights were *vested*, and prohibited the state from tampering with a settled agreement. Under substantive due process, the rights were *substantive*—they were defined in the first instance by the courts and protected whether or not they had been the subject of an earlier private bargain.

Although the two were sometimes compared,[45] the contract clause and substantive due process protected different interests and often yielded irreconcilable results. Both the contract clause and substantive due process set federal limits on state power to control business corporations, but the doctrines were developed within antagonistic economic models. The most notable opposing pair of Supreme Court decisions are the *Charles River Bridge* case[46] of 1837 and the *Slaughter-House Cases*[47] of 1873. In *Charles River*

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in question, are regulations of the remedy, and not of the right. . . . If those acts so change the nature and extent of existing remedies, as materially to impair the rights and interests of the owner, they are just as much a violation of the compact, as if they directly overturned his rights and interests.").

41. *See* Ogden v. Saunders, 25 U.S. (12 Wheat.) 213, 266-68, 303-04 (1827) (state may not pass bankruptcy law that discharges debts contracted prior to enactment); Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 199 (1819) (states may not pass laws that discharge obligations of bankrupt party).

42. *See* Mason v. Haile, 25 U.S. (12 Wheat.) 370, 378 (1827) (state may abolish imprisonment for debt); *Sturges*, 17 U.S. (4 Wheat.) at 200-01 (state may refuse to imprison debtors and still not impermissibly interfere with right to contract).

43. *See Sturges*, 17 U.S. (4 Wheat.) at 206-207 (statute of limitations does not interfere with right to contract).

44. *See* Pound, *Liberty of Contract* 18 YALE L.J. 454, 454 (1909) (including within definition of "liberty of contract" right to purchase and sell labor without government interference).

45. *See* Egan, *Protection to Contracts by the Due Process of Law Clauses in the Federal Constitution*, 36 AM. L. REV. 70, 89-91 (1902) (comparing due process clause with contract clause).

46. Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420 (1837).

47. Slaughter-House Cases, 83 U.S. (16 Wall.) 36 (1873).

Bridge, a divided Supreme Court rejected the argument that the contract clause required a monopoly privilege be implied in a corporate charter even though no such privilege was explicit in the grant.[48] In the *Slaughter-House Cases*, a divided Court rejected the argument that the due process clause of the fourteenth amendment forbade a state from placing a monopoly privilege in a corporate charter.[49]

The strong view of the contract clause that was developed during the Marshall era considered monopoly rights essential to economic development, and many prominent lawyers such as Joseph Story[50] and lawyer/political economist Daniel Raymond [51] believed these rights deserved constitutional protection. Although Story conceded that not every corporate charter implied a monopoly right, he argued that at least those charters for works of public improvement, such as bridges, should be so construed.[52] On the other hand, under the strong view of substantive due process emerging in the 1870s, monopoly was an abomination, and the monopoly of an ordinary business was not justified merely because it was authorized in a charter from the state. The right of every person to practice a lawful occupation was thought to deserve federal constitutional protection. In less than forty years, a mere change in prevailing economic theory had stood the Constitution on its head.

This change in constitutional doctrine, from an emphasis on vested rights to an emphasis on substantive rights, resulted from several interrelated developments in American economic growth and accompanying legal theory. First was the change in economic theory from a mercantilist regime, in which state grants of vested rights were considered essential for economic development, to a classical regime, in which the ideal state granted little or nothing but ouly protected the right to bargain and engage in lawful enterprise. Second was the rise of the modern business corporation itself and the collapse of several legal doctrines that had distinguished corporations from other forms of business organization.[53] Third, the decline in contract clause jurisprudence was part of a broader movement by American legal writers and courts, to view the corporation as a "person," just as any natural person engaging in business. This view originated in Chief Justice Taney's diversity jurisdiction decisions[54] and became fully developed after the Court held that

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48. 36 U.S. (11 Pet.) at 549-53.

49. 83 U.S. (16 Wall.) at 77-82. For a brief history of the facts surrounding the *Slaughter-House Cases*, see Hovenkamp, *Technology, Politics, and Regulated Monopoly: An American Historical Perspective*, 62 TEX. L. REV. 1263, 1295-1308 (1984).

50. *See Charles River Bridge*, 36 U.S. (11 Pet.) at 608 (Story, J., dissenting) (arguing that economic investment in public works depends upon grant of exclusive monopoly rights).

51. *See infra* text accompanying notes 89-94.

52. *Charles River Bridge*, 36 U.S. (11 Pet.) at 639 (Story, J., dissenting); M. HORWITZ, *supra* note 1, at 118.

53. *See infra* Part VII-D.

54. *See infra* text accompanying notes 358-63.

a corporation is a person for purposes of the fourteenth amendment.[55]

2. Two Branches of Contract Clause Jurisprudence

Although the legislative history of the contract clause is scant and ambiguous, the framers of the Constitution were concerned principally with state attempts to relieve debtors from their creditors.[56] The framers also expressed concern with *ex post facto* legislation,[57] and both the contract clause and the *ex post facto* clause were frequently discussed together.[58] Nowhere in this scant history appears even a hint that the contract clause referred to land grants or corporate charters from the state. Indeed, the framers were concerned almost exclusively with *private* contracts—those between two individuals, such as a debtor and a creditor—and not with states' reneging on past grants.[59]

Nevertheless, Benjamin Wright observed in 1938 that "[m]uch the largest and most important group of cases under the contract clause is that having to do with the regulation of corporate enterprise."[60] In fact, by the Taney period a century earlier, the contract clause had become the principal constitutional limit on state power over corporations. Distinct "private" and "public" branches of contract clause jurisprudence had emerged, each having little to do with the other. The private branch governed state impairment of previously negotiated contracts between individuals. The public branch governed legislative impairment of state corporate grants and, to a lesser extent, public land grants[61] when the state itself was a party to the bargain for which protection was sought.

55. *See infra* text accompanying notes 320-46.

56. On the drafting of the contract clause, see B. WRIGHT, THE CONTRACT CLAUSE OF THE CONSTITUTION 4-33 (1938); Hale, *The Supreme Court and the Contract Clause* (pts. 1-3), 57 HARV. L. REV. 512, 621, 852 (1944). On the intent of its various framers, see F. MCDONALD, NOVUS ORDO SECLORUM: THE INTELLECTUAL ORIGINS OF THE CONSTITUTION 274 (1985). For an extraordinary account of the clause, see Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 718-30 (1984) (arguing that contract clause provides substantive due process protection for economic rights).

57. The application of the *ex post facto* clause to regulatory and corporate law issues was undermined by the Supreme Court's decision in Calder v. Bull, 3 U.S. (3 Dall.) 386, 397 (1798) (applying clause only to criminal statutes).

58. *E.g.*, Ogden v. Saunders, 25 U.S. (12 Wheat.) 213, 286 (1827). In the corporate literature, see treatise writer Francis Wharton's critique that rate regulation of an incorporated firm whose charter did not reserve the rate-setting power to the state amounted to *ex post facto* legislation as well as impairment of an obligation of contract. Wharton, *Retrospective Legislation and Grangerism*, 3 INT'L REV. 50 (1876). *See also* Brewer, *Protection to Private Property from Public Attack*, 55 NEW ENGLANDER & YALE REV. 97, 108-10 (1891) (Justice Brewer equates the destruction of contractual rights with *ex post facto* legislation); Atwater, *The Regulation of Railroads*, 7 (series 4) PRINCETON REV. 406 (1881).

59. *See* B. WRIGHT, *supra* note 56, at 15-17.

60. *Id.* at 127.

61. On the separate subject matter of these areas of the ease law, see *id.* chs. 5 & 6.

Although scholars have widely noted that the Taney Court and its successors emasculated the Marshall Court's contract clause doctrine,[62] they have not observed that this emasculation occurred almost exclusively within the "public" domain of contract clause jurisprudence. Beginning with the *Charles River Bridge* case in 1837,[63] Chief Justice Taney began tugging at the foundation of the Marshall era contract clause interpretations by allowing states greater latitude in regulating corporations. However, the Taney Court also continued vigorous protection of creditors from state debtor relief statutes.[64] Thus, the supposed transformation from vested to substantive rights against the state was nothing more than a reversal in the way the federal courts limited state power over business corporations.

B. THE POLITICAL ECONOMY OF MARSHALL COURT CONTRACT CLAUSE JURISPRUDENCE

The most important Marshall era contract clause decisions are *Fletcher v. Peck*,[65] *Dartmouth College v. Woodward*,[66] *Sturges v. Crowinshield*,[67] and *Ogden v. Saunders*.[68] In *Fletcher*, the Court held that the contract clause forbade a state from rescinding a prior land grant; the earlier grant was a contract with the grantees which the rescinding act presumed to impair.[69] *Dartmouth College* held that a state could not unilaterally amend a previously granted corporate charter, for the charter constituted a contract between a state and the charter's recipients and could not be changed without mutual consent unless the charter itself permitted such modification.[70] Although Dartmouth College was a charitable corporation, the decision also applied to business corporations.[71]

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62. *E.g.* Kainen, *supra* note 39, at 384 (Marshall Court contract clause cases overruled by Taney Court).

63. 36 U.S. (11 Pet.) 420 (1837).

64. *See infra* Part II-C-1 (examining private debt relief cases decided by Taney Court).

65. 10 U.S. (6 Cranch) 87 (1810).

66. 17 U.S. (4 Wheat.) 518 (1819).

67. 17 U.S. (4 Wheat.) 122 (1819).

68. 25 U.S. (12 Wheat.) 213 (1827); *see also* Green v. Biddle, 21 U.S. (8 Wheat.) 1 (1823) (holding contract between two states unconstitutionally impaired by one state's breach); B. WRIGHT, *supra* note 56, at 53 n. 96 (listing other Marshall Court contract clause decisions).

69. 10 U.S. (6 Cranch) at 135-37; *see also* Terrett v. Taylor, 13 U.S. (9 Cranch) 43, 50-55 (1815) (applying contract clause reasoning in holding that statute confirming church's title in land could not be repealed and state could not expropriate land).

70. 17 U.S. (4 Wheat.) at 638.

71. *See* Providence Bank v. Billings, 29 U.S. (4 Pet.) 514, 560 (1830) ("It has been settled, that a contract entered into between a state and an individual, is as fully protected by the tenth section of the first article of the constitution, as a contract between two individuals; and it is not denied, that a charter incorporating a bank is a contract.").

However, *Dartmouth College* generally did not apply to municipalities or other public corporations. It was clear to Marshall that "the framers of the Constitution, did not intend to restrain the states in the regulation of their civil institutions adopted for internal government." *Dartmouth Col-*

In *Sturges*, the Court held that a state could not pass legislation discharging the pre-existing debt of someone who agreed to put up all of his property for payment, no matter how great the shortfall.[72] When a debtor and creditor enter a contract, they ordinarily contemplate that payment will be taken not merely from the property the debtor may own at a given time but also from any property he may acquire in the future. "Future acquisitions are, therefore, liable for contracts; and to release them from this liability impairs their obligation."[73] Finally, the *Ogden* Court held, over Chief Justice Marshall's dissent, that a state bankruptcy law could be applied to debts incurred *after* the statute took effect but not to private contracts that had previously been executed.[74]

Most Marshall era contract clause decisions did not explicitly address state policy toward economic growth, except to assert that states encouraged progress by honoring debtor-creditor arrangements and standing behind their land grants. But the Federalists who came to political power after the American Revolution were greatly concerned with economic growth. The key issue was how to achieve optimal growth. The scant history of the contract clause suggests that its framers had in mind a particular danger to economic growth: the threat to American creditworthiness that might result from state debtor relief legislation passed during the 1780s recession.[75] This concern was equally consistent with the mercantile political economy of the day and the classicism that followed.[76]

Federalist and classical interpretations of the contract clause were not far apart on issues of the sanctity of contract but were poles apart on the question of state subsidy. Although mercantilists may have been more willling to upset a contract when they perceived substantive unfairness, enforcement of

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lege, 17 U.S. (4 Wheat.) at 629. Since the state could therefore alter the charter of a public corporation, it was essential for Marshall to decide that a nonprofit college was a private rather than a public corporation. *Id.* at 634-41. The Taney Court later applied this rule in East Hartford v. Hartford Bridge Co., 51 U.S. (10 How.) 511 (1850), holding that a charter to a municipality is not a contract but a "public license," which the legislature can amend. *Id.* at 536; *see also* T. M. COOLEY, A TREATISE ON THE CONSTITUTIONAL LIMITATIONS WHICH REST UPON THE LEGISLATIVE POWER OF THE STATES OF THE AMERICAN UNION 331-32 (6th ed. 1890) (state can modify municipal charters if public interest so justifies).

The view that the contract clause did not apply to municipal corporations was not unanimously held. For example, Chancellor James Kent often objected to state-imposed revisions of the governance structures of municipalities, because they required revision of municipal charters. *See* R. SEAVOY, *supra* note 11, at 237-240.

72. *Sturges*, 17 U.S. (4 Wheat.) at 206.

73. *Id.* at 198.

74. 25 U.S. (12 Wheat) at 312-13.

75. See *supra* note 56 and accompanying text (describing origin of contract clause).

76. For example, Francis Wharton observed that Benjamin Franklin was conspicuous among members of the convention as a "student of political economy" who believed "that justice and expediency require that freedom of contract should be absolute." F. WHARTON, COMMENTARIES ON AMERICAN LAW 549 (1884).

private contracts was critical to both economic models.[77] For example, in his 1790 *First Report on the Public Credit,*[78] Alexander Hamilton urged that American economic development required good internal as well as external credit, which would occur only if all debts were paid when due.[79] However, Hamilton then proposed an array of taxes and duties in order to help fund that debt.[80]

Mercantilist and classical policy diverged sharply on questions about the relationship between the state and economic development, and thus on the proper relationship between the state and the developing business corporation.[81] Under the mercantilist view, the state should be an active participant in economic development. For example, in his 1791 *Report on Manufactures,*[82] Hamilton urged an array of bounties, subsidies, quotas, duties, and import and export prohibitions in order to encourage nonagricultural industry.[83] Hamilton argued that, although growth in manufacturing would occur as American reliance on agriculture drove its economy to a subsistence level, it would come much more quickly and at lower cost if encouraged by the government.[84] He recommended that the government fund investments in new plant and equipment with debt that the investors would eventually pay off themselves.[85] However, Hamilton also encouraged widespread use of bounties on locally manufactured goods financed by a duty on imported goods[86]—a suggestion that would have been anathema to most classicists half a century later. Hamilton concluded that bounties promoted exports

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77. *See* M. HORWITZ, *supra* note 1, at 160-73 (reviewing history of contract enforcement). *But see* Simpson, *The Horwitz Thesis and the History of Contracts*, 46 U. CHI. L. REV. 533, 542-88 (1979) (criticizing Horwitz's view of transformation of contract law).

78. A. HAMILTON, PAPERS ON PUBLIC CREDIT, COMMERCE AND FINANCE 1 (McKee ed. 1934).

79. *Id.* at 4-5.

80. *Id.* at 40-43.

81. The best general study of mercantilist political economy is E. HECKSCHER, MERCANTILISM (2d ed. 1955). *See also* G. BEER, THE OLD COLONIAL SYSTEM, 1660-1754 (1912) (on mercantilism in Colonial America); F. McDONALD, *supra* note 56, ch. 4 (on Federalists and mercantilism generally).

82. A. HAMILTON, *supra* note 78, at 175.

83. *Id.*; *see* J. COOKE, ALEXANDER HAMILTON 100 (1982) (concluding that Hamilton's mercantilist political economy "set forth economic doctrines that Smith's *Wealth of Nations* was designed to topple"); *see also* J. MILLER, ALEXANDER HAMILTON: PORTRAIT IN PARADOX 290-95 (1959).

84. A. HAMILTON, *supra* note 78, at 204.

85. *Id.* at 214-17.

86. One per cent duty on the foreign article, converted into a bounty on the domestic, will have an equal effect with a duty of two per cent, exclusive of such a bounty; and the price of the foreign commodity is liable to be raised, in the one case, in the proportion of one per cent; in the other, in that of two per cent. Indeed, the bounty, when drawn from another source, is calculated to promote a reduction of price; because, without laying any new charge on the foreign article, it serves to introduce a competition with it, and to increase the total quantity of the article in the market.

Id. at 236.

and would turn America into a producer, rather than a consumer, nation.[87] He argued that bounties were "indispensable to the introduction of a new branch" of manufacturing, although they might not be as important for well-established industries.[88]

America's first comprehensive treatise on political economy was published by Daniel Raymond in 1820,[89] then expanded in 1823 and entitled *The Elements of Political Economy.*[90] Raymond's two-volume work is the only significant text on political economy by a nineteenth-century American who clearly preceded the classical tradition.[91] Raymond himself was a Massachusetts lawyer who studied at the Litchfield Law School in the 1810s. His book won the admiration of John Jay, John Adams, and John Marshall.[92]

Like Hamilton, Raymond believed that high tariffs were necessary to encourage domestic production and that government intervention was necessary to ensure economic growth. Much of Raymond's book was an attack on the laissez-faire attitude toward government expressed by Adam Smith's *Wealth of Nations.*[93] For example, Raymond noted that Smith's work had turned "monopoly" into a forbidden word among political economists.[94] He then argued that many great works of government were monopolies. Although Raymond conceded that many monopolies held by private entrepreneurs proved bad, "[t]here are numerous instances in which, for the purpose of accomplishing some specific object, or for the attainment of some national benefit, it may be expedient and useful to grant a private monopoly for a certain period."[95] Raymond added:

> A nation may be desirous of establishing some useful manufactory, or to open some new sources of trade, which is expected to be useful and important to the nation, at some future period; and for the attainment of these

87. *Id.* at 237.

88. *Id.* at 238; *see* F. MCDONALD, *supra* note 56, at 102-03 (discussing system of bounties and subsidies in Colonial Massachusetts).

89. D. RAYMOND, THOUGHTS ON POLITICAL ECONOMY (Baltimore 1820).

90. D. RAYMOND, THE ELEMENTS OF POLITICAL ECONOMY (Baltimore 1823).

91. Francis Bowen, political economist at Harvard at the middle of the nineteenth century, was an unreconstructed Federalist who objected to many features of the new classicism. For example, he approved granting monopoly rights to corporations as inducements to their taking risks for the public benefit. F. BOWEN, PRINCIPLES OF POLITICAL ECONOMY 226-27 (1859). Classicists roundly condemned such grants. *See* J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY Book 5, ch. 10, § 3, at 562-63 (1872).

92. On Raymond, see *C. Neill, Daniel Raymond, An Early Chapter in the History of Economic Theory in the United States*, in JOHNS HOPKINS UNIVERSITY STUDIES IN HISTORICAL AND POLITICAL SCIENCE 217 (H. Adams ed. 1897); M. O'CONNOR, ORIGINS OF ACADEMIC ECONOMICS IN THE UNITED STATES 33 (1944).

93. A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (London 1776); 1 D. RAYMOND, *supra* note 90, chs. 16 & 17 (attacking theoretical basis of Smith's theory); 2 *id.* ch. 8 (attacking laissez-faire government).

94. 2 D. RAYMOND, *supra* note 90, at 163.

95. *Id.* at 173.

> objects, it may be expedient to create a private monopoly for a limited period. This monopoly may be granted to a single individual, to a company, to a corporation, or to some particular town; and although the rest of the nation may be excluded from the benefit of it, still as the object is to promote national interests, and as it is the duty of every citizen to forego his own private advantage for the public good, no one will have a right to complain.[96]

Raymond's theory reflected a legal and economic regime in which monopoly rights were granted by corporate charters, and private corporate charters—at least for franchises—were read to imply monopoly rights.[97] From the onset, American states and local governments used an array of public and private inducements to encourage economic development, including public works projects,[98] taxation, subsidies,[99] and grants of monopoly rights to turnpike, bridge,[100] and even some railroad corporations.[101] Although classicism, with its laissez-faire attitude toward economic development, came to dominate American political economy and even the American judiciary,[102] it never succeeded as well in controlling state and local policymaking. The statist mercantile theory of economic growth always had attractions for politicians that laissez-faire theory could not match.

The constitutional commentator who best expressed this preclassical theory of the corporation was Justice Story. The second edition of his *Commentaries on the Constitution*[103] was published in 1851, after he had some time to reflect on the major classical decision of the Taney Court, *Charles River Bridge*,[104] in which he had written a long dissent. The majority's holding that a corporate charter did not imply a monopoly enraged Story because it undermined the state's obligation to bargain in good faith. Good faith could be protected only if charters were construed liberally and in favor of the incorporators "to secure them in the enjoyment of what is actually granted," at least when the corporation's function confers a valuable benefit on the

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96. *Id.* at 174.

97. *See* Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420, 639 (1837) (Story, J., dissenting) (corporations created for public benefit should have implied monopoly rights).

98. *See* H. N. SCHEIBER, OHIO CANAL ERA: A CASE STUDY OF GOVERNMENT AND THE ECONOMY, 1820-1861, at 36-54 (1969) (Ohio State government construction of canal projects).

99. *See* C. GOODRICH, *supra* note 3, at 230-62 (describing state and local grants and tax concessions for railroad development).

100. *See* M. HORWITZ, *supra* note 1, at 124-39 (discussing development of state-granted monopolies to bridge corporations).

101. *See* Hovenkamp, *supra* note 3, at 1038 (describing monopoly road grants).

102. *See* Hovenkamp, *Political Economy*, *supra* note 1, at 384-401 (arguing that classical theories of political economy were bases for liberty of contract).

103. J. STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES (Boston 2d ed. 1851). The first edition was published in 1833, before *Charles River Bridge* was decided.

104. Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420 (1837).

public.[105]

The sovereign's good faith consideration, Story concluded, included "not merely the granting of a right to build a bridge, but an implied contract, to restrict themselves from interfering to impair or destroy the value of that grant."[106] Had the legislature originally included a proviso that, if the bridge were successful the state would be free to charter a second bridge, "the inadequacy and insecurity of the consideration, would have prevented any prudent man from accepting the charter."[107]

In Story's eyes the corporation was an important and distinctive mechanism for encouraging economic development. He viewed subsidies, preferences, and protection from competition as necessary, for development involving great risk would not occur unless those engaged in it were offered substantial protection, whether from competition or from subsequent state interference with their activities. A policy of strict construction would make future investors more reluctant, since their investment might be undermined by unanticipated state usurpation of assumed rights.

C. CLASSICISM AND THE OBLIGATION OF CONTRACT

Even during the Federalist period there was substantial dissent from the Hamiltonian approach to state encouragement of economic growth. The Jeffersonians, particularly James Madison, objected that subsidies and bounties would encourage only "artificial" types of manufacturing that needed subsidies to survive. The Jeffersonians believed that the state should encourage whatever manufacturing developed naturally, since it would be best suited to a developing nation.[108] While conceding that the self-supporting manufacturers might be less sophisticated or refined, at least in the early stages, Madison believed they would be good in the long run precisely because they were self-supporting.

Early Jeffersonian "classicism" drew heavily on the writing of Adam Smith, the great critic of mercantilism and founder of classical political economy.[109] But Jeffersonian thought was motivated by an agrarian ideology. Jefferson envisioned the United States as a nation of farmers, "those who labour in the earth."[110] He feared that manufacturing subsidies and bounties

105. *Id.* at 547-48.

106. *Id.*

107. *Id.*

108. 6 WRITINGS OF MADISON 100 (G. Hunt ed. 1900-1910).

109. *See* D. McCoy, THE ELUSIVE REPUBLIC: POLITICAL ECONOMY IN JEFFERSONIAN AMERICA 175 (1980) (republican analysis paralleled discussion in *The Wealth of Nations*).

110. NOTES ON THE STATE OF VIRGINIA 164-65 (W. Peden ed. 1955) ("generally speaking, the proportion which the aggregate of the other classes of citizens bears in any state to that of its husbandmen, is the proportion of its unsound to its healthy parts, and is a good-enough barometer whereby to measure its degree of corruption.")

would drain the farm economy and encourage development of a privileged class of the kind that accounted for so many of England's problems.[111] Aggressive, pro-industrial classical political economy did not emerge until the early 1820s; with the rise of the Jacksonian movement. The Jacksonian classicists usually agreed with Hamilton rather than Madison about ultimate goals—encouragement of manufacturing and public works—but differed with Hamilton about the best mechanism for encouraging such development.[112]

One would hardly think that classical political economy would weaken the role of contract in society. In a variety of senses, classicism represented the "triumph" of contract.[113] Under the classical theory, the contract was the preeminent expression of the individual will, and courts rigorously protected its sanctity from legislative interference.[114] The fundamental premise of the "invisible hand" was that private bargaining would yield the optimal distribution of goods and services.

But the classical revolution could succeed only if given the fair chance. The state had to extricate itself as much as possible from such "preclassical" entanglements as state and municipal subsidies designed to attract new business, cash grants, tax exemptions, grants of the right to injure the property of others, and grants of monopoly rights.

Preclassical and classical political economy differed in a number of important ways, but no difference was greater than their respective views about how to encourage economic development. In both cases, the theory was casually empirical. Federalist political economy developed at a time when capital was relatively hard to come by and economic growth was perceived as slow. As a result, the Federalist tended to view new investments as risky. High initial cost was certain, and future income depended on the uncertain development of new demand.

But the classicist—particularly the American classicist—faced a changed world. Although capital was still scarce, economic growth was not. Even more important was classicism's theory of competition and politics. In a properly functioning market, businesses that produced the goods and ser-

111. *Id.* at 161.

112. *See* Hovenkamp, *Political Economy, supra* note 1, at 413 (Jacksonian majority believed that people should be able to manage their affairs with minimal interference).

113. *See* M. HORWITZ, *supra* note 1, at 173-88 (explaining rise of free-will theory in contract law); P. S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT (1979) (free market proposals of political economists influential in establishing freedom of contract); *cf.* Hovenkamp, *Political Economy, supra* note 1, at 384-401 (classical laissez-faire economics basis for economic substantive due process).

114. *See* Lochner v. New York, 198 U.S. 45 (1905) (striking down maximum hours statute); *In re* Jacobs, 98 N.Y. 98 (1885) (striking down statute forbidding cigar manufacturing in tenement houses). The best history of the theory is P. S. ATIYAH, *supra* note 113.

vices that people wanted and at a price that they were willing to pay, would enter the market and survive. Businesses that did this best would grow and enter new markets, while those that did not would languish. Monopoly grants, tax exemptions, direct subsidies, or other special privileges were viewed as bad, because they permitted politics rather than entrepreneurial skill to determine what kinds of businesses would enter the market and survive. By definition, the business that deserved to prosper within the classical scheme was the one that did not *need* a subsidy. Thus, under classical constitutional theory, state courts and eventually the Supreme Court began invalidating a variety of subsidies to manufacturing concerns.[115]

1. The Classical Contract Clause During the Taney Era

a. Supreme Court Decisions

(1) The Classical Contract Clause and Debtor-Creditor Regulation. The classical contract clause as developed by the Taney Court implied a high regard for the sanctity of private contracts but the narrowest possible interpretation of earlier state grants of developmental privileges. As noted above, any suggestion that the Taney Court undermined Marshall era contract clause jurisprudence must distinguish between "private" and "public" contract clause opinions. With regard to private contracts and debtor-creditor relations, the Taney Court maintained the strong Marshall position. In *Bronson v. Kinsie*[116] Chief Justice Taney, writing for the Court, held that a statutory right of redemption on a foreclosed mortgage was unconstitutional when applied to a mortgage executed before passage of the statute.[117] Likewise, in *Gnatly's Lessee v. Ewing*[118] the Court unanimously struck down an Indiana statute forbidding the sale of foreclosed property for less than half its appraised value, when applied to a foreclosure decree entered before the statute was passed.[119] In *Howard v. Bugbee*[120] the Court condemned retroactive application of a statute permitting mortgagors to redeem foreclosed property within two years of foreclosure by paying the purchase price plus interest and costs.[121]

Finally, in *Gelpcke v. City of Dubuque,*[122] a controversial case decided at

115. *See infra* text accompanying notes 291-319.

116. 42 U.S. (1 How.) 311 (1843).

117. *Id.* at 319; *see also* McCracken v. Hayward, 43 U.S. (2 How.) 608, 612-13 (1844) (invalidating as unconstitutional state law which which did not allow sale of property to satisfy judgment unless property sold for two-thirds of appraised value).

118. 44 U.S. (3 How.) 707 (1845).

119. *Id.* at 717; *see also* Planters' Bank v. Sharp, 46 U.S. (6 How.) 301 (1848) (invalidating under contract clause Mississippi statute forbidding bank communication of evidence of debt).

120. 65 U.S. (24 How.) 461 (1861).

121. *Id.* at 465.

122. 68 U.S. (1 Wall.) 175 (1864).

the end of Chief Justice Taney's tenure, the Supreme Court held that a state's invalidation of a municipality's bonds impaired the obligation of a contract between the municipality and bondholders, notwithstanding an earlier state court decision that the bonds had been issued illegally.[123] The case pitted the classical principles of respect for contract and laissez-faire developmental policy against each other. The bonds had been issued to subsidize railroad construction, but the Iowa Supreme Court declared them invalid and struck down the subsidy, upsetting the debtor-creditor relationship in the process. By overruling that decision, the Taney Court indicated that while state subsidies are bad, disrespect for contract is even worse.

During the remainder of the classical period, the Supreme Court retained the Taney Court's strong position on private contracts, a position entirely consistent with classicism's desire to protect the sanctity of private bargains. For example, in *Gunn v. Barry*[124] and *Edwards v. Kearzy*[125] the Court struck down retroactive application of state homestead exemptions from private debts.[126] In fact, the Court struck down every attempt to modify retroactively a debtor-creditor relationship to the creditors' detriment unless the modification affected only the remedy rather than the substantive right.[127] The Supreme Court maintained this position until the 1934 decision in *Home Building & Loan Association v. Blaisdell*,[128] when constitutional classicism was in its death throes.

(2) The Classical Contract Clause and the Corporation. Taney court decisions on the public branch of contract clause jurisprudence are a different matter. The Supreme Court's first great classicist corporations decision was the *Charles River Bridge* case of 1837[129] in which the Court held that corporate charters must be strictly construed.[130] The Taney court expanded this position at every opportunity, substantially restating it in 1850.[131] In 1848, the court held in *West River Bridge Co. v. Dix*[132] that a charter giving a corporation a one hundred year privilege to operate a bridge could be taken under the state's eminent domain power. Effectively, a state could buy itself

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123. *Id.* at 206.

124. 82 U.S. (15 Wall.) 610 (1873).

125. 96 U.S. 595 (1878).

126. 82 U.S. (15 Wall.) at 623-24; 96 U.S. at 607.

127. *See* B. WRIGHT, *supra* note 56, at 68-82.

128. 290 U.S. 398, 444-48 (1934) (sustaining Depression-era statute placing moratorium on mortgage foreclosures).

129. Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420 (1837).

130. *Id.* at 544-46.

131. Mills v. County of St. Clair, 49 U.S. (8 How.) 569, 582-83 (1850) (reading exclusive ferry-running contract narrowly to allow second ferry).

132. 47 U.S. (6 How.) 507, 532-33 (1848). The case is discussed further in Scheiber, *The Road to* Munn: *Eminent Domain and the Concept of Public Purpose in the State Courts*, in LAW IN AMERICAN HISTORY 379 (D. Fleming & B. Bailyn eds. 1971).

out of a previous entanglement. Since the fifth amendment was not applied to the states for another half century, this gave the states great power to rescind charters without substantial concern about the federal courts.[133] In the wake of *Dix*, one state court held that the contract clause was satisfied if the new, competing corporation compensated the old corporation for the loss of its monopoly right.[134]

In *Fanning v. Gregoire*[135] the Taney Court went one step further, holding that a state charter granting a corporation the right to operate a ferry and guaranteeing that no county could authorize the establishment of a competitor did not prevent the state legislature from authorizing a competing line.[136] Similarly, in *Richmond Railroad*,[137] the Court held that a grant giving a railroad the exclusive right to carry passengers between Richmond and Fredericksburg did not prohibit authorization of a competing freight line or a parallel passenger line operating *part* of the distance between those two points.[138] Finally, in *Bridge Proprietors v. Hoboken Co.*[139] it held that a charter expressly giving a tollroad company the exclusive right to operate a bridge[140] did not prevent the legislature from chartering a railroad to build a parallel bridge. In an outrageously disingenuous opinion, the Court reasoned that since trains could not pass over the plaintiff's bridge, and since the newer bridge serviced only railroads, the two bridges did not compete and the proprietors' rights were unimpaired.[141] Of course, this ignored the fact that *all* freight, whatever its overland mode of transport, had to cross the river either by bridge or boat. The two bridges did compete, and the construction of the second bridge certainly damaged the value of the plaintiffs' franchise.

Taney applied every available argument to permit states to withdraw from

133. *See* Chicago, Burl. & Q.R.R v. Chicago, 166 U.S. 226, 242-48 (1897) (railroad company has 14th amendment complaint only when substantially no compensation for loss of land grant). Throughout the 1880s and early 1890s the Court had fairly consistently said that state takings raise no federal issue. *See* Fallbrook Irrigation Dist. v. Bradley, 164 U.S. 112, 158-59 (1896) (upholding state court decision that acts mandating irrigation program not violation of federal or state constitution); Thorington v. Montgomery, 147 U.S. 490, 491-92 (1893) (loss of property for overdue city taxes raised no federal question); Davidson v. New Orleans, 96 U.S. 97, 104-05 (1877) (state real estate assessment not violative of federal constitution if done in accordance with state laws).

134. Boston & Low. R.R. v. Salem & Low. R.R., 68 Mass. (2 Gray) 1, 26 (1854), (holding grant of competing railroad impaired plaintiff railroad's charter, but that problem could be cured if defendant compensated plaintiff for loss of monopoly right).

135. 57 U.S. (16 How.) 524 (1853).

136. *Id.* at 534.

137. Richmond, Fred. & Pot. R.R. v. Louisa R.R., 54 U.S. (13 How.) 71 (1851).

138. *Id.* at 89.

139. 68 U.S. (1 Wall.) 116 (1864).

140. The charter provided "that it should not *be lawful* for any person or persons whatsoever to erect, or cause to be erected . . . , *any other bridge or bridges* over or across said river." *Id.* at 118 (emphasis in original).

141. *Id.* at 149-50.

entanglements with private corporations. As President Jackson's Attorney General, he had earlier written a legal opinion asserting that states did not have the power to grant monopoly rights, implying that corporations did not have these rights even if they were explicit in their grants.[142] Twenty years later, writing for the Supreme Court as Chief Justice, Taney suggested that many, if not most, corporate charters were politically ill-advised. Taney took judicial notice that almost every bill of incorporation

> is drawn originally by the parties who are personally interested in obtaining the charter; and that they are often passed by the legislature in the last days of its session, when, from the nature of our political institutions, the business is unavoidably transacted in a hurried manner, and it is impossible that every member can deliberately examine every provision in every bill upon which he is called on to act.
>
> On the other hand, those who accept the charter have abundant time to examine and consider its provisions, before they invest their money.[143]

The one inconsistency in the Taney Court's record on corporations involved cases interpreting charter provisions that gave corporations special relief from taxes. Sometimes the Court construed corporation charters very narrowly to permit the state to impose subsequent taxes.[144] But in other cases, it held that the tax impaired the obligation created under the charter.[145] Most of the decisions were made by divided courts and are as much explained by the Taney Court's hostility to taxation as by its narrow construction of corporate charters. These decisions may also represent the Court's reluctance to hurry the classical revolution.

Several of the tax decisions grew out of a series of Ohio cases exhibiting extreme state court disregard of federal law. In one such case, a Jacksonian Ohio legislature had passed a statute modifying the charters of several state banks, thereby increasing their tax liability beyond the limits expressed in their original grants.[146] The Ohio Supreme Court found the modifications valid, stating that Chief Justice Marshall had erred in holding bank charters to be "contracts."[147] Additionally, the court concluded that the banks, cre-

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142. *See* M. HORWITZ *supra* note 1, at 135.

143. Ohio Life Ins. & Trust Co. v. Debolt, 57 U.S. (16 How.) 416, 435-36 (1853).

144. *See* Armstrong v. Athens County, 41 U.S. (16 Pet.) 281, 289 (1842) (act of state legislature granting tax-exempt status to state university property does not entitle subsequent purchaser to tax-exempt status); *Debolt*, 57 U.S. (16 How.) at 441 (insurance company charter providing that company would be taxed no higher than banks did not prevent state from taxing banks and insurance companies together more than other businesses).

145. *See* Gordon v. Appeal Tax Court, 44 U.S. (3 How.) 133, 150 (1845) (enforcing charter provision that bank would be subject to no further taxes); Piqua Branch of the State Bank v. Knoop, 57 U.S. (16 How.) 369, 380-82 (1853) (enforcing charter provision basing bank's tax liability on stipulated percentage of its profits).

146. Knoup v. Piqua Branch of the State Bank, 1 Ohio St. 603, 605-06 (1853).

147. *Id.* at 613.

ated for the enrichment of the stockholders and not for any public good, had failed to provide adequate "consideration" for their grants.[148] Finally, it decided that no legislature could convey away the power to tax and, therefore, subsequent legislatures always could alter tax commitments made in an earlier charter.[149] The Taney Court quickly rejected the state court's conclusion that a bank charter is not a contract.[150] However, the Court did accept the Ohio court's argument about the power to tax.[151] Although the Ohio Supreme Court initially acquiesced in the United States Supreme Court's holdings,[152] a year later it changed its mind, declared the decisions not binding, and once again sustained the statute modifying the charters. This resulted in another Supreme Court decision protecting the banks' rights under their original charters.[153]

b. State Reservations. Ohio was not the only state to experience the Jacksonian revolution, although few were as aggressive about asserting it. During the Taney period, the general reservation clause or statute, giving the state the power to amend corporate charters, became the principal mechanism by which states hedged on commitments to business corporations. The Supreme Court consistently upheld such reservations, provided that they applied only to corporations chartered after passage of the reservation statute.

Statutory reservation clauses began to appear at the beginning of the nineteenth century. An 1809 Massachusetts statute provided that the legislature could "from time to time" amend any corporate charter or even repeal it by giving notice to the corporation,[154] and an 1805 Virginia statute contained a similar provision.[155] Justice Story appeared to approve of such reservations

148. *Id.* at 619-21.

149. This analysis is found in the following cases: Debolt v. Ohio Life Ins. Co., 1 Ohio St. 563 (1853); Mechanics' & Traders' Bank v. Debolt, 1 Ohio St. 591 (1853); Knoup v. Piqua Branch of the State Bank, 1 Ohio St. 603 (1853); Bank of Toledo v. Toledo, 1 Ohio St. 622 (1853). The cases are discussed in J. POMEROY, AN INTRODUCTION TO THE CONSTITUTIONAL LAW OF THE UNITED STATES 368-74 (1868).

150. Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855) (charter provision setting rate of taxation is binding contract); Ohio Life Ins. and Trust Co. v. Debolt, 57 U.S. (16 How.) 416, 416 (1853) (same); Piqua Branch of the State Bank v. Knoop, 57 U.S. (16 Howard) 369, 380 (1853) (bank charter fixing tax obligation is binding contract and may not be impaired by subsequent tax increases).

151. *Piqua Branch of the State Bank,* 57 U.S. (16 How.) at 389-90.

152. *See* Ross County Bank v. Lewis, 5 Ohio St. 447, 449 (1856) (holding that bank charter prescribing taxation is binding contract); State v. Moore, 5 Ohio St. 444, 446-48 (1856) (same); Matheny v. Golden, 5 Ohio St. 361, 366-75 (1856) (holding that act of state legislature making university property non-taxable is binding contract).

153. Skelly v. Jefferson Bank, 66 U.S. (1 Black) 436, 450 (1861).

154. *Laws of Mass.* May session, 1806, to January session, 1809, at 467; *see* B. WRIGHT, *supra* note 56, at 59.

155. B. WRIGHT, *supra* note 68, at 59.

in *Dartmouth College v. Woodward*,[156] suggesting that a state could repeal or change a charter if it had reserved the power to do so in advance.[157] Although it was unclear at the time whether the reservation had to appear in the charter of each corporation or whether the state could pass a statute applicable to all future corporations, later Supreme Court decisions found both acceptable.

During the Jackson era, state hostility toward private monopoly was the most obvious manifestation of the new classicism in political economy. In addition to placing antimonopoly provisions in their constitutions, many states inserted constitutional reservation clauses. In 1831, Delaware became the first state to place a general reservation clause in its constitution.[158] By the end of the Civil War fourteen states had enacted similar clauses, some even purporting to give state legislatures the power to revoke the charters of earlier corporations.[159] For many states the problem of state commitments to specially chartered corporations was no longer an issue, at least if the corporation was chartered after passage of the reservation act. Older corporations continued to enjoy the advantages granted in their charters, although many of these were substantially undermined by the Supreme Court.[160] Thus, the burden of state-created monopolies weighed heavier on the original colonies (especially New England, New York, and Pennsylvania), which had issued many such charters during colonial and Federalist times, than on the western and Mississippi Valley states, which had issued few.

2. The Classical Contract Clause After the Civil War

a. The Treatise Tradition. By the time classicism became the dominant judicial theory in the last half of the nineteenth century, state and local governments had entangled themselves in economic development in a way that was anathema to classicism's theory of economic growth. Literally thousands of business subsidies had been granted—and as many charters had been created—giving their recipients tax exemptions, monopoly rights, or other special privileges that undermined the classical theory of efficient business development.

The judiciary responded to this problem by developing a set of doctrines designed to limit the states' power to subsidize new business. Of these, the public purpose doctrine was the most important, although the takings doctrine and substantive due process[161] later served the same purpose. These

156. 17 U.S. (4 Wheat.) 518 (1819).

157. *Id.* at 712.

158. DEL. CONST. of 1831, art. II, § 17.

159. *E.g.*, LA. CONST., title VI, art. 124 (1845) (giving legislature "the power to revoke the charters of all corporations whose charters shall not have expired" by 1890).

160. *See supra* text accompanying notes 129-43.

161. *See* Hovenkamp, *Political Economy*, *supra* note 1, at 389 (citing a range of state cases in

doctrines forced government to place new and prospective businesses on an equal footing so that the best would rise to the top.

But compensating for past damage posed an equally serious problem. Once a business had received a tax break, a special right to injure the property of others, or—worst of all—a monopoly privilege, competitive incentives in that market were forever destroyed. No one could compete on equal terms with those having such artificial advantages. In short, classicism's principle of economic development would work properly only if, liberty of contract notwithstanding, the sovereign was permitted to extricate itself from past commitments. The principal role of classical contract clause jurisprudence was to facilitate this disentanglement, consistent with classicism's own especially high regard for the sanctity of contract. We have already seen how the Taney Court began this task. It would be completed by its successors.

The great treatise writers in the Jacksonian tradition took up the mantle of classicism as well. Often their work dealt with economic policy more explicitly than the Supreme Court's opinions. For example, Thomas M. Cooley, author of *Constitutional Limitations*,[162] believed that the task of undoing the damage caused by the *Dartmouth College*[163] decision was as important as the protection of substantive property rights against the state.[164] Although much has been written about Cooley's considerable influence on the police power and substantive due process, little attention has been paid to his position on the contract clause.[165] He attacked the Marshall era contract clause at every opportunity, both in his judicial opinions and treatise writing. In *East Saginaw Manufacturing Co. v. City of East Saginaw*,[166] Cooley's most important contract clause opinion as Chief Justice of Michigan's Supreme Court,[167] he adopted the position Taney took in the *Charles River Bridge*[168] case. Cooley's dicta had broader implications for future Supreme Court decisions.

In 1859 Michigan had passed a statute designed to encourage salt manu-

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which substantive due process was used to strike down licensing laws that erected barriers to entry by new businesses into existing markets).

162. T. COOLEY, A TREATISE ON THE CONSTITUTIONAL LIMITATIONS WHICH REST UPON THE LEGISLATIVE POWER OF THE STATES OF THE AMERICAN UNION (2d ed. 1871).

163. 17 U.S. (4 Wheat.) 518 (1819).

164. *See infra* text accompanying notes 178-82 (describing Cooley's disagreement with *Dartmouth College*).

165. *But see* Jones, *Thomas M. Cooley and the Michigan Supreme Court: 1865-1885*, 10 AM. J. LEG. HIST. 97, 101-10 (1966) (examining Cooley's contributions to contract clause cases).

166. 19 Mich. 259 (1869).

167. Also important are Gale v. Kalamazoo, 23 Mich. 354 (1871) (holding that municipality's breach of contract that gave plaintiff monopoly not actionable because original promise unreasonable) and Walcott v. People, 17 Mich. 68 (1868) (state constitutional reservation of power to subject corporations to specific taxes did not, by implication, destroy power to levy other kinds of taxes).

168. 36 U.S. (11 Pet.) 420 (1837).

facturing.[169] The statute offered a ten cent bounty on each bushel produced and exempted salt-producing land from property taxes. In 1861 the statute was amended to reduce the amount of the bounty and to limit the tax exemption to five years.[170] When the plaintiffs' tax exemption expired and the City of East Saginaw attempted to collect property taxes, the plaintiff sued to enjoin enforcement, claiming that the 1861 amendments impaired a contractual obligation created by the original 1859 statute.[171]

Cooley held that the 1859 statute was neither a contract nor a tax exemption but was instead a mere promise not to tax, unenforceable because it exceeded the state's power.[172] The taxing power was one of the "essential powers of sovereignty, which the State must exercise again and again, as often as its needs or its interests may require."[173] As a result, Cooley held, it cannot be "crippled or abridged" by a mere promise.[174] Cooley also observed:

> It is upon this ground that it has been so often and so earnestly denied by learned and able jurists, that it is within the grant of authority to any legislative body, chosen as representatives of the people, to enter into any contract by which they bargain away any portion of the power to levy taxes . . . .[175]

Finally, and most radically, Cooley stated that every statute implies a right of repeal, and a promise not to tax should be treated no differently.[176] "The absence of any express reservation of the right to repeal, or of any limitation in time, is not therefore a fact of any significance . . . ."[177]

Cooley's academic writing on the contract clause was even more to the point. He appended this footnote to the discussion of the *Dartmouth College* case in the 1871 revision of his *Constitutional Limitations* treatise:

> It is under the protection of the decision in the Dartmouth College Case that the most enormous and threatening powers in our country have been created; some of the great and wealthy corporations actually having greater influence in the country and upon the legislation of the country than the states to which they owed their corporate existence. Every privilege granted or right conferred—no matter by what means or on what pretense—being made inviolable by the Constitution, the government is frequently found stripped of its authority in very important particulars, by

169. *East Saginaw Mfg. Co.*, 19 Mich. at 270.
170. *Id.* at 270-71.
171. *Id.* at 271.
172. *Id.* at 273.
173. *Id.* at 272-73.
174. *Id.* at 273.
175. *Id.*
176. *Id.*
177. *Id.*

unwise, careless or corrupt legislation.[178]

The result, Cooley concluded, was that "a clause of the federal Constitution, whose purpose was to preclude the repudiation of debts," has been interpreted in such a way as to perpetuate the evil of entrenched corporate power.[179]

Cooley took every opportunity to limit the scope of corporate charters. He advocated broad application of the view that a state could not contract away its police powers[180] and attempts to do so in private corporate charters were void.[181] He suggested, for example, that a state could not exempt a corporation from the state's eminent domain power. If the state promised in a charter to exercise its police power on behalf of a corporation, the promise "must be considered as only a valuable portion of the privilege secured by the grant, and as such liable to be appropriated under the power of eminent domain."[182] Cooley was apparently untroubled by the illogic of arguing that a granted right to be free from eminent domain is a mere property interest that can be taken under the state's eminent domain power if just compensation is paid.[183]

But what of the state's power to create monopolies? Some Jacksonians, such as Roger Taney[184] and the dissenters in the *Slaughter-House Cases*[185] denied that the state had a "police power" to create them at all.[186] The

178. T. COOLEY, *supra* note 162, at 335; *cf.* Trickett, *The Dartmouth College Paralogism*, 40 AM. L. REV. 175 (1906) (criticizing *Dartmouth* for making state supervision of corporations impossible).

179. T. COOLEY, *supra* note 162, at 167.

180. The Supreme Court eventually followed. *See* Manigault v. Springs, 199 U.S. 473 (1905) (upholding statute authorizing one land owner to flood another's land in spite of preexisting contract prohibiting flooding). The Court found that the statute, which encouraged the construction of dams and other works of public improvement, was within the state's police power.

> [T]he interdiction of statutes impairing the obligation of contracts does not prevent the State from exercising such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public, though contracts previously entered into between individuals may thereby be affected.

Id. at 480. The Court noted, for example, that a statute forbidding lotteries or regulating the liquor trade could be applied to invalidate contracts executed before the statute was passed. *Id.*

181. T. COOLEY, *supra* note 162, at 333-37.

182. *Id.* at 339.

183. Isaac Redfield, prominent railroad law scholar and Chief Justice of the Vermont Supreme Court, took the same position as Cooley, noting that incorporated firms were always subject to the general regulatory power of the state respecting public nuisances or other activities harmful to the public. The "law-making power of all free states" is something that resides "perpetually and inalienably in the legislature," and cannot be granted away. Thorpe v. Rutland & Burl. R.R., 27 Vt. 140, 149 (1854).

184. *See* M. HORWITZ, *supra* note 1, at 135 (discussing Taney's argument that legislature lacked the capacity to limit the power of its successors by contracting to create a monopoly).

185. 83 U.S. (16 Wall.) 36, 83 (1873).

186. *Id.* at 87-89 (Field, J., dissenting).

Slaughter-House majority, however, believed otherwise,[187] so Cooley discarded the issue as settled in the third and subsequent editions of *Consitutional Limitations*. Nevertheless, he read the *Slaughter-House* decision extraordinarily narrowly on the police power issue. First, Cooley distinguished corporate charters involving franchises from those involving general occupations. States could create monopoly rights in bridges and ferries, he concluded, because states controlled the right to build and operate such structures in the first place.[188] But since 1602,[189] the sovereign lacked constitutional power to create monopolies for common callings, such as butchers: "the grant of a monopoly in one of the ordinary and necessary occupations of life must be as clearly illegal in this country as in England."[190]

However, the charter upheld in the *Slaughter-House Cases* did just that. It created a monopoly of a common calling— butchering. Instead of calling the decision wrong, Cooley interpreted the *Slaughter-House Cases* to mean that, while competitors of the incorporated firm could not challenge the monopoly grant as beyond the state's power, the state itself was not bound by the grant.[191] Therefore, he argned, the state could later repeal the monopoly grant even though the contract clause forbade it from repealing a similar grant to a properly defined franchise, such as a gas light company. The Supreme Court eventually accepted both positions.[192] The distinction between the repealability of monopolies given to ordinary business and those

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187. *Id.* at 61-62.

188. T. COOLEY, *supra* note 162, at 343 n.1.

189. Cooley was undoubtedly referring to The Case of Monopolies, 11 Coke 84b, 77 Eng. Rep. 1260 (K.B. 1602) (applying common law to deny enforcement of royal grant giving grantee exclusive right to manufacture and import playing cards).

190. T. COOLEY, *supra* note 162, at 342. Cooley continued:

> and it would be impossible to defend and sustain [such a power], except upon the broad ground that the legislature may control and regulate the ordinary employments, even to the extent of fixing the prices of labor and of commodities. As no one pretends that the legislature possesses such a power . . . it must follow that lawful grants of special privileges must be confined to cases where they will take from citizens generally nothing which before pertained to them as of common right.

Id. at 342-43.

191. *See* T. COOLEY, *supra* note 162, at 343 n.1 ("the legislature could not by a grant of this kind make an irrepealable contract"); *see also* Norman, *Legal Restraints on Modern Industrial Combinations and Monopolies in the United States*, 33 AM. L. REV. 499, 504 (1899) (legislature can revoke grant of monopoly).

192. On the first, see Butcher's Union Slaughter-House & Live-Stock Landing Co. v. Crescent City Live-Stock Landing & Slaughter-House Co., 111 U.S. 746, 753-54 (1884) (holding that, since one legislature could not bind subsequent legislature's ability to exercise police power, subsequent legislature had authority to destroy butcher's monopoly). On the second, see St. Tammany Water Works v. New Orleans Water Works, 120 U.S. 64, 67 (1887) (later legislature cannot rescind monopoly grant to water works); Louisville Gas Co. v. Citizens' Gas Co., 115 U.S. 683, 695 (1885) (same, gas light utility); New Orleans Gaslight Co. v. Louisiana Light & Heat Producing Mfg. Co., 115 U.S. 650, 672-73 (1885) (same).

given to "franchises" signaled the emergence of the "public utility" corporation, which was treated differently from ordinary manufacturers. By the turn of the century these utilities were governed by a distinct body of law.[193]

In one respect Cooley's contract clause position proved more moderate than Taney's. Although Cooley may have shared the Taney Court's loathing of monopoly and special privilege, he had a higher opinion of the liberty of contract and therefore of corporate charters, since they were contracts. This placed Cooley in the difficult position of protecting the sanctity of contract, which classical political economy demanded, while diminishing prior state entanglements that were essentially contractual.

The tension between Cooley's respect for freedom of contract and his hatred of monopoly and special privilege appears in two essays he wrote in 1878 and 1883 on legislative regulation of business.[194] Cooley adamantly opposed rate regulation in most industries, not because of any implied rights in the corporate charters, but rather because he believed the fourteenth amendment limited state regulatory powers. In other words, the constraint on state power did not depend on whether the target was incorporated.[195]

Cooley conceded that the common law required certain firms, such as common carriers, to charge reasonable rates but argued that reasonable rates are generally determined by competition, not by courts or legislatures.[196] The state should acquire power to determine reasonableness only when a company receives special privileges, such as eminent domain or a monopoly, for such privileges free the firm from competition.[197] The state's power to regulate, Cooley concluded, comes from the company's monopoly position, not it's corporate charter.

Some charters, however, might give corporations both monopoly status and freedom from regulation. Cooley observed that ever since the great Yazoo land fraud,[198] legislatures were subject to corruption and often gave certain individuals special privileges where no public interest required them.[199] In such cases, Cooley wrote, "the State must abide by the grant, and if it was improvident, must suffer the consequences."[200] Under those circumstances, the state, at best, could scrutinize the corporation's activities,

193. *See infra* text accompanying notes 271-74.

194. Cooley, *Limits to State Control of Private Business*, 1 PRINCETON REV. (series 4) 233 (1878) [hereinafter Cooley, *State Control*]; Cooley, *State Regulation of Corporate Profits*, 137 N. AM. REV. 205 (1883) [herinafter Cooley, *Corporate Profits*].

195. Cooley, *State Control*, *supra* note 194, at 239-40, 243.

196. Cooley, *Corporate Profits*, *supra* note 194, at 210.

197. *Id.* at 210-211; *see also* Cooley, *State Control*, *supra* note 194, at 265 (stating same proposition).

198. The fraud culminated in the Supreme Court's decision in Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810). *See supra* text accompanying notes 65-94.

199. Cooley, *State Control*, *supra* note 194, at 234-35.

200. Cooley, *Corporate Profits*, *supra* note 194, at 207.

construe its charter strictly, and revoke its charter if the corporation exceeded its terms.[201] Cooley suggested that even if a charter had given a railroad the power to set its own rates, the state still retained the power to determine whether or not the rates were reasonable.[202] The Supreme Court adopted this position in the *Railroad Commission Cases,*[203] emasculating the contract clause as a limit on state corporate control.

If Cooley provided the creative impulse for substantive due process, Francis Wharton furnished its orthodox restatement. Wharton, a clergyman who turned to the law and became one of the nineteenth century's most prominent treatise writers, was nothing if not orthodox. His writing is generally important not for its brilliant creativity, for it showed little, but because it reflected the consensus position so well.

In the case of the contract clause, however, Wharton saw more clearly than Cooley the relationship between the classical corporation and American economic growth, as well as the potential threat posed by Federalist contract clause jurisprudence. While Cooley was concerned with equal access to business opportunities and abolition of special privileges, Wharton was concerned about making way for new technology, which both monopolies and special privilege undermined. In his 1884 *Commentaries on American Law*[204] Wharton argued that the *Dartmouth College* decision no longer should be regarded as controlling; it had been imperfectly argued and the Court had never adequately considered its statement about the unalterable nature of corporate grants,[205] an omission that in Wharton's mind proved unfortunate for future economic development:

> The policy of irrevocably granting away public franchises, and fixing social rights in a constant perpetual mould, has become far more questionable with the lapse of years than it was at the time of the business of the country was only slowly recovering from the paralysis produced by the war of 1812; when, in fact, as to machinery or facilities of transportation, there had been no material change since the Constitution had been adopted. In those days, therefore, when an apparently permanent type had been assumed by society, there was nothing startling in the position that an adjustment of social rights made by any particular legislature should bind forever. Now, however, we have been taught by the great inventions of steam and of the telegraph, by the marvellous improvements of machinery by which industries of all kinds have been remodelled, and by the introduction of new

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201. *Id.* at 212.

202. *Id.*

203. Stone v. Farmers' Loan & Trust Co., 116 U.S. 307 (1886); Stone v. Ill. Cent. R.R., 116 U.S. 347 (1886); Stone v. New Orleans & N.E.R.R., 116 U.S. 352 (1886). *See infra* text accompanying notes 222-31.

204. F. WHARTON, *supra* note 76.

205. *Id.* at 483, 554.

> staples displacing old, that the stationary and apparently immutable condition of society during the first quarter of the present century was exceptional, and that the normal type of social life, as of all other kinds of life, is mutability tending to development.[206]

Wharton acknowledged that the *Dartmouth College* rule may have been harmless when applied to universities or other charitable institutions, but it had no application to the charters of business corporations. Wharton preferred the English rule "that business franchises granted by the legislature can, in all cases, be recalled and modified when the public interests require, provided that in this way private property is not taken without adequate compensation."[207]

In his important turn-of-the-century treatise on the police power,[208] Christopher G. Tiedeman identified the classical theory of the corporation as the reason behind both the narrowing application of the contract clause to corporations and the expansion of substantive due process rights. Although Tiedeman maintained an extremely narrow view of the state's "police power," or authority to regulate,[209] he regarded any doctrine allowing corporate charter exemption from future exercises of the state's police power as an affront:

> [T]he intention of a legislature to place a private corporation beyond the reach of the police power of the State—to grant to a corporation the right to do what is pleases in the exercise of its corporate powers, it matters not how much injury is inflicted upon the public, and yet be subject to no control or restraint, which is not provided by the laws in force when the charter was granted—is so manifestly unreasonable, that we cannot suppose that the legislature so intended, unless this extraordinary privilege is expressly granted.[210]

Private business corporations were not unique creatures deserving special

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206. *Id.* at 556.

207. *Id.* at 557. In a footnote he drew his most explicit conclusion about the consequences of the Marshall era contract clause rule for economic growth:

> Were a restriction, like that before us, imposed on the British constitution, British economical growth would have been stopped. There is scarcely an abuse existing, or that has existed within the last century in Great Britain, that has not had legislative sanction, and that does not involve contractual rights . . . . In this country the disaster arising from attaching immobility and fixity to the legislation of any particular has worked less injuriously, from the fact that our charters are comparatively recent, while some of those which came up for revision in England were granted centuries ago.

Id. at 557 n. 2.

208. C. G. TIEDEMAN, A TREATISE ON STATE AND FEDERAL CONTROL OF PERSONS AND PROPERTY IN THE UNITED STATES (1900).

209. *See* C. JACOBS, LAW WRITERS AND THE COURTS 58-63 (1954) (explaining Tiedeman's narrow police-power theory).

210. C. TIEDEMAN, *supra* note 208, at 952.

protection, Tiedeman argued. Rather, "an act of incorporation simply guarantees to the incorporators the right to act and do business as a corporate body, subject, of course, to the laws of the land, and the legitimate control of government."[211] Consequently, the legal *status* of the corporation, as an artificial person, does not differ from the natural person, except so far as the charter may reserve or grant special privileges or impose peculiar burdens.[212] Tiedeman concluded that state policy toward corporations must be like state policy toward natural persons, subject to change with the times.[213] Tiedeman strongly believed that the state must retain flexibility in its available actions in controlling corporations: "[t]o recognize in a legislature the power by a contract to tie the hands of all future legislatures, and deprive them of the power to interpose regulations that may become needful of the protection to the public against the aggressions or other unlawful acts of the corporations, would be a specimen of political suicide."[214]

b. The Classical Contract Clause under Chase, Waite and Fuller. From the Civil War until the end of the nineteenth century, the Supreme Court never departed from the direction Taney had taken. Although continuing to use the contract clause to enforce private debtor-creditor agreements, the Court all but abandoned the idea that a corporate charter was a contract providing the corporation with vested privileges.

During this period business corporations frequently lost contract clause arguments on rationales flatly inconsistent with Marshall era holdings.[215] In a series of 1870s and 1880s decisions, the Court upheld state general reservation acts making all subsequently enacted charters subject to the statutes' provisions.[216] *Northwestern Fertilizing Co. v. Hyde Park*[217] involved a corporate charter allowing a company to operate a chemical plant at a designated site for fifty years. This provision notwithstanding, the Court allowed the state to close the plant as a public nuisance to houses built after the plant's incorporation.[218] In *Ruggles v. Illinois*[219] the plaintiff railroad corporation

211. *Id.*

212. *Id.* at 952-93 (emphasis in original).

213. *Id.* at 959.

214. *Id.* at 960.

215. For a comprehensive summary of the cases, see A. Russell, *Status and Tendencies of the Dartmouth College Case*, 30 AM. L. REV. 321 (1896).

216. *See* Spring Valley Water Works v. Schottler, 110 U.S. 347, 355-56 (1884) (holding that state could repeal provision of charter allowing corporation to select members of utilities rate board); Greenwood v. Freight Co., 105 U.S. 13, 22 (1881) (state may repeal charter entirely); Shields v. Ohio, 95 U.S. 319 (1877) (state may impose rate ceiling on railroad even though not in charter); Peik v. Chicago & N.W. Ry., 94 U.S. 164, 176 (1877) (same). *See supra* text accompanying notes 158-60.

217. 97 U.S. 659 (1878).

218. *Id.* at 670.

219. 108 U.S. 526 (1883).

had a charter authorizing it to set its own rates in its bylaws, provided that the bylaws did not conflict with state law.[220] The Court held that the legislature could nevertheless subsequently set rates for the railroad since its bylaws would otherwise conflict with state law.[221]

Most significantly, in the *Railroad Commission Cases,*[222] the Court held that, although the plaintiff railroads' charters expressly authorized them to fix rates, the grant implicitly required the rates to be reasonable and were silent about who determines reasonableness.[223] As a result, the states' railroad commissions could set rail rates, and the railroads had power only to "fix" the rates established by the commissions. However the charters had not limited the railroads to fixing "reasonable" rates. For example, one charter empowered the company "to fix, regulate and receive the toll and charges by them to be received,"[224] while another allowed the corporation's officers to "adopt and establish such a tariff . . . as they may think proper, and the same to alter and change at pleasure."[225] The Court circumvented the plain meaning of the charters by reasoning that they implicitly incorporated the common law, which required common carrier rates to be reasonable.[226] From that premise the Court concluded:

> The power to charge being coupled with the [implied] condition that the charge shall be reasonable, the State is left free to act on the subject of reasonableness within the limits of its general authority as circumstances may require. The right to fix reasonable charges has been granted, but the power of declaring what shall be deemed reasonable has not been surrendered.[227]

In his dissent, Justice Field suggested that the majority had abused the common law.[228] He pointed out that the common law reasonable rate requirement provided that the rate be sufficient to give the company a fair return on the current market value of its assets. In this case, however, "improvements in machinery" and "decline in the cost of materials" had re-

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220. The bylaws stated in part that "[t]he board of directors shall have power to establish such rates of toll . . . as they shall from time to time by their by-laws determine." *Id.* at 530.

221.
> When . . . a section of the charter . . . expressly declares that no by-law shall be made that is in conflict with the laws of the state [and] the rates of change to be levied and collected . . . are to be regulated by the by-laws, the conclusion is irresistible that only such charges can be collected as are allowed by the laws of the state.

Id. at 533.

222. Stone v. Farmers' Loan & Trust Co., 116 U.S. 307 (1886); Stone v. Ill. Cent. R.R., 116 U.S. 347 (1886); Stone v. New Orleans & N.E.R.R., 116 U.S. 352 (1886).

223. 116 U.S. at 328-30, 351-52, 354-55.

224. *Farmers' Loan & Trust Co.*, 116 U.S. at 325.

225. *Illinois Cent. R.R.*, 116 U.S. at 351.

226. *Farmer's Loan & Trust Co.*, 116 U.S. at 329-330.

227. *Id.*

228. *Id.* at 342 (Field, J., dissenting).

duced railroad construction costs by one-third.[229] As a result, railroads built when costs were high would receive an inadequate return on their historical investment if the commissions adopted the common law rule. "Does anybody believe, Field asked rhetorically, that the railroads" would have undertaken the work . . . had they been informed that, notwithstanding their vast outlays, they should only be allowed . . . to receive a fair return upon its value, however much less than cost that might be?"[230]

Nevertheless, the *Railroad Commission Cases* tolled the death knell of the mercantile theory that the charter was a contract with the state according unique privileges to the incorporated firm.[231]

III. REGULATION AND INCORPORATION: THE RISE OF REGULATED INDUSTRY

Mercantile political economy did not trust the market to allocate resources and believed that government controls on price and entry were necessary.[232] Classicism, on the other hand, believed that the market was better than any alteruatives at setting price and output. Although Adam Smith distinguished between "natural" and "market" prices,[233] his successors quickly secularized that view until, by the time of John Stuart Mill, a "just" price, if it existed, was nothing other than the price set by the market.[234] Furthermore, although classicism gradually developed a concept of "market failure" that justified price regulation in certain markets, these instances were much less common than was perceived during the mercantile period.[235]

In the waning years of mercantilism, the corporate charter became the principal institutional device for state price regulation. In his treatise *de Portibus Maris*,[236] written in the 1670s but first published a century later, Lord

229. *Id.* at 344.

230. *Id.*

231. *Id.* at 325-26, 333. In Keith v. Clark, 97 U.S. 454 (1878), the Court found that legislative amendment of a bank charter violated the contract clause. However, in this case the amendment—a declaration that notes previously issued by the bank were void—upset pre-existing debtor-creditor relations between the bank and its noteholders.

232. On price regulation in seventeenth century America, see J. HUGHES, SOCIAL CONTROL IN THE COLONIAL ECONOMY 132-135 (1976). For a summary of other historical work, see F. MCDONALD, *supra* note 56, at 14-15.

233. *See* Young, *The Impartial Spectator and Natural Jurisprudence: An Interpretation of Adam Smith's Theory of the Natural Price*, 18 HIST. POL. ECON. 365, 381 (1986) (concluding that Smith actually distinguished market from natural price).

234. *See* E. PAUL, MORAL REVOLUTION AND ECONOMIC SCIENCE: THE DEMISE OF LAISSEZ-FAIRE IN NINETEENTH-CENTURY BRITISH POLITICAL ECONOMY 155-67, 220 (1979) (reviewing theories of Mill and assumptions of that era).

235. *See* Hovenkamp, *Political Economy*, *supra* note 1, at 440 (discussing classical concept of business "affected with the public interest").

236. Lord Hale, *De Portibus Maris*, in A TREATISE IN THREE PARTS (c. 1670), *reprinted in* 1 A COLLECTION OF TRACTS RELATIVE TO THE LAW OF ENGLAND 45 (F. Hargrave ed. 1787).

Hale argued that price regulation was appropriate only for industries "affected with publick interest."[237] Blackstone believed such industries were "prerogatives of the Crown," that is, activities one could engage in only with a charter.[238] By the eighteenth century, most price-regulated markets were industries for which a corporate charter was required. The charter itself was a convenient and unquestionably legal way for the state to regulate a firm's rates. For example, the 1785 charter in the *Charles River Bridge* case[239] and the 1869 charter in the *Slaughter-House Cases*[240] set rates that the corporations could charge.[241] Most state price regulation during the eighteenth and early nineteenth centuries was accomplished through the use of corporate charters.[242]

Even at the time of *Munn v. Illinois*,[243] when the Supreme Court first affirmed the constitutionality of rate regulation of unincorporated enterprises, some considered the existence of a corporate charter empowering the state to regulate a firm's price to be essential. Justice Field dissented from the *Munn* majority's reading of Lord Hale's *de Portibus Maris* to say that rate regulation was appropriate any time an industry was identified by the state as "affected with the public interest."[244] Rather, the concept of "affected with the public interest" applied only to chartered business corporations and only they could be subject to rate regulation. When counsel for the state noted several Supreme Court cases upholding rate regulation, Field responded that these were "mostly cases of public ferries, bridges, and turnpikes, of wharfin-

237. *Id.* at 78.

238. 1 W. BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 263-64, 273 (1765-1769); *see also* J. CHITTY, JR., *supra* note 4, at 122 (corporations chartered for maintenance of public policy, government, trade, sciences, etc.).

239. 36 U.S. (11 Pet.) 420 (1837).

240. 83 U.S. (16 Wall.) 36 (1873).

241. *See* S. KUTLER, PRIVILEGE AND CREATIVE DESTRUCTION: THE CHARLES RIVER BRIDGE CASE 10 (1971) (quoting Charles River Bridge Charter's price-regulation provisions); *see also* Hovenkamp, *supra* note 49, at 1291 n. 164. The price provisions of the charter creating the Crescent City Live-Stock Landing and Slaughter-House Company can be found in the *Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 42 (1873). *See also* Hovenkamp, *supra* note 49, at 1303 n. 228.

242. *See* 2 J. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 227-30 (1917) (charters of canal, bridge, and turnpike corporations included regulation of tolls).

243. 94 U.S. 113 (1877).

244. *Id.* at 139 (Field, J., dissenting). Justice Field noted that, when Hale spoke of property "affected by public interest" he

> referred to property dedicated by the owner to public uses, or to property the use of which was granted by the government, or in connection with which special privileges were conferred. Unless the property was thus dedicated, or some right bestowed by the government was held with the property, either by specific grant or by prescription of so long a time as to imply a grant originally, the property was not affected by any public interest so as to be taken out of the category of property held in private right.

Id. at 139-40.

gers, hackman, and draymen, and of interest on money."[245] In all except the last case some special privilege had been granted by the State, and

> [t]he conditions upon which the privilege shall be enjoyed being stated or implied in the legislation authorizing its grant, no right is, of course, impaired by their enforcement. The recipient of the privilege, in effect, stipulates to comply with the conditions. It matters not how limited the privilege conferred, its acceptance implies an assent to the regulation of its use and the compensation for it.[246]

Classical political economy was hostile to rate regulation and reluctant to expand its scope. No pre-Civil War American classicist argued that rate regulation should be administered by general statute rather than special charter. With the rise of the railroad, however, even classicists began to realize that competition was not always the best way to determine price and output.[247] Railroads had higher operating costs than earlier price-regulated industries such as turnpikes and toll bridges. The largest cost of operating a toll bridge or turnpike was the historical capital investment, since operating costs were extremely small. The railroads, by contrast, required fuel and labor for their operations. As a result, a corporate charter permanently fixing rail rates was too inflexible. Rates set by a legislature or commission, on the other hand, could be changed as costs changed.

By the 1870s and 1880s, American political economists began to develop a theory of rate regulation for industries, particularly railroads, in which competitive pricing did not work.[248] The emerging classical regulatory theory was different from mercantilist theory because it was market-based rather than firm-based. The mercantile theory of rate regulation argued that monopoly privileges were necessary to encourage particular firms to enter certain industries. As a result, the same contract that granted the monopoly should fix maximum rates, since competition would no longer control prices. But as classicism matured and responded to market failure in the rail industry, the nature of the business rather than the charter status of the firm determined whether price regulation was appropriate. Classicists concluded that railroads should be subject to price regulation not because they had charters or monopoly privileges—most railroad charters did not confer monopoly rights—but because high fixed costs, low variable costs, imperfect competi-

245. *Id.* at 148.
246. *Id.* at 148-149.
247. Hovenkamp, *supra* note 3, at 1035-44.
248. *E.g.*, A. T. HADLEY, RAILROAD TRANSPORTATION: ITS HISTORY AND LAWS 63-74 (1885); C.F. Adams, Jr., *The Railroad System*, in C. ADAMS & H. ADAMS, CHAPTERS OF ERIE AND OTHER ESSAYS 360-66 (1871); Adams, *The Government and the Railroad Corporations*, 112 N. AM. REV. 31 (1871); Bacon, *Railways and the State*, 30 NEW ENGLANDER & YALE REV. 713 (1871); Potts, *The Science of Transportation*, (no. 2) J. SOC. SCI. 115 (1870); Seligman, *Railway Tariffs and the Interstate Commerce Laws*, 2 POL. SCI. Q. 222, 222-27 (1887).

tion, and price discrimination seemed inherent in the structure of the industry.[249]

The resulting switch in state policy from contractual to statutory rate regulation schemes quickly followed the Supreme Court's approval of the statutory rate regulation of both incorporated and unincorporated firms in the *Granger* cases.[250] This policy switch effectively "de-privatized" rate regulation and paved the way for modern regulatory theory and the emergence of distinctive legal rules for "franchise," or public utility, corporations.

The *Granger* cases dealt with the constitutionality of Illinois, Wisconsin, Minnesota, and Iowa statutes regulating rates of private firms. All of the cases except *Munn v. Illinois*[251] involved the power of the state to regulate the rates of incorporated railroads.[252] *Munn,* the case selected by the Court for a full opinion, involved price regulation of Munn & Scott, an unincorporated elevator company.

Almost a decade after *Munn,* Justice Miller revealed in *Wabash, St. Louis and Pacific Railway Co. v. Illinois,*[253] that *Munn* had been selected for a full opinion on state power to regulate prices because the company was unincorporated:

> [T]he case of *Munn v. Illinois* was selected by the court as the most appropriate one in which to give its opinion on [state power to limit tolls and charges], because that case presented the question of a private citizen, or unincorporated partnership, engaged in the warehousing business in Chicago, free from any claim of right or contract under an act of incorporation of any State whatever. . . . And in that case the court was presented with the question, which it decided, whether any one engaged in a public business, in which all the public had a right to require his service, could be regulated by acts of the legislature in the exercise of this public function and public duty, so far as to limit the amount of charges that should be made for such services.[254]

Justice Miller continued by noting that the railroads in the companion cases

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249. *See* Hovenkamp, *supra* note 3, at 1044.

250. Munn v. Illinois, 94 U.S. 113 (1876); Chicago, Burl. & Q.R.R. v. Iowa, 94 U.S. 155 (1876); Peik v. Chicago and N.W. Ry., 94 U.S. 164 (1876); Chicago, Milw. & St. Paul R.R. v. Ackley, 94 U.S. 179 (1876); Winona & St. Peter R.R. v. Blake, 94 U.S. 180 (1876); Stone v. Wisconsin, 94 U.S. 181 (1876).

251. 94 U.S. 113 (1876).

252. Chicago, Burl. & Q.R.R. v. Iowa, 94 U.S. 155, 164 (1876) (upholding Iowa statute establishing maximum rates for railroads); Peik v. Chicago and N.W. Ry., 94 U.S. 164, 178 (1876) (upholding state power to set maximum rates); Chicago, Milw. & St. Paul R.R. v. Ackley, 94 U.S. 179, 179 (1876) (upholding validity of maximum rates for transporting property on railroads in Wisconsin); Winona & St. Peter R.R. v. Blake, 94 U.S. 180, 180 (1876) (upholding charter binding railroad to charge only reasonable rates); Stone v. Wisconsin, 94 U.S. 181, 183 (1876) (upholding Wisconsin Supreme Court decision that railroad company charter subject to repeal or alteration).

253. 118 U.S. 557 (1886).

254. *Id.* at 569.

had raised an argument unavailable to Munn & Scott, "namely, that in their charters from the States they each had a contract, express or implied, [that] they might regulate and establish their own fares and rates of transportation."[255] In *Peik v. Chicago and North-western Railway Company,*[256] one of *Munn*'s companion cases, the Court upheld statutory rate regulation because railroads were "clothed with the public" interest.[257] The Court concluded that an incorporated railroad's charges could be regulated "unless restrained by some contract."[258]

The railroads in the *Granger* cases argued that a state constitutional provision authorizing the legislature to amend or repeal any act of incorporation could not be construed to permit a charter amendment that reasonable incorporators would never have accepted. They argued that:

> [N]othing more could have been intended than to leave the stockholders in corporations in such a position that the legislature could place them on the same footing with natural persons before the law, and disable them from permanently evading the burdens on all others engaged in similar vocations, by appealing to the letter of their charter. Their object was not to open the door to oppression, but to secure simple equality between citizens of the State, whether working singly or in corporate associations.[259]

This argument, based on an "associational" view of the business corporation, urged that a corporation shonld have the same right as everyone else to be free of unbargained-for rate regulation. But the argument proved to be a two-edged sword. The railroads relied on the theory that rate regulation had always been a two-way "contractual" arrangement between the corporation and the state. Certainly the Wisconsin legislature could not use its power to amend a corporate charter to impose rate regulation on a corporation unilaterally. In the absence of a contract the corporation deserved to be treated the same as an unincorporated association. The charter amendment "does, without any doubt, have that effect," Chief Justice Waite conceded.[260] He then stood the argument on its head by upholding rate regulation of natural persons provided the regulated *market* was "affected with the public interest." Since railroads are clearly "affected with the public interest," under their own argument they were subject to rate regulation once natural persons were.[261]

Chief Justice Waite noted in another *Granger* decision that during charter negotiations the company conld have bargained with the state to "fix perma-

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255. *Id.*
256. *Peik*, 94 U.S. 164.
257. *Id.* at 177-78
258. *Id.* at 176.
259. *Id.* at 175-76.
260. *Id.*
261. *Id.*

nently" in the charter a limit on price regulation.[262] "If that had been done, the charter might have presented a contract against future legislative interference. But it was not."[263] In the absence of such charter protection, the railroad should be treated as anyone else.

Munn, coupled with the Court's emasculation of the contract clause, made corporate status irrelevant to the states' power to regulate rates.[264] In fact, the Court went to extraordinary lengths to permit states to regulate corporations' rates when charters apparently allowed them to set their own rates. For example, in *Stone v. Wisconsin*,[265] one of *Munn*'s companion cases, the Wisconsin territorial legislature had chartered the Milwaukee and Waukesha Railroad in 1847, two years before Wisconsin became a state. The charter stated that the company could "demand and receive such sum or sums of money for passage and freight of persons and property as they shall from time to time think reasonable."[266] The charter also provided that the company would be formally organized when it received $100,000 of paid-in capital. This did not occur until April 5, 1849. Meanwhile, Wisconsin had become a state, and its constitution provided that corporate charters "may be altered or repealed by the legislature at any time after their passage."[267] The Court coucluded that since the corporation was organized after the constitution took effect, it was subject to the constitution, though the charter was issued before ratification of the constitution.[268]

After *Munn*, state power to regulate rates depended on whether or not the firm was "affected with the public interest." Writing in 1900, Christopher Tiedeman drew a more technical distinction, perhaps based on three decades of experience with the difficulties of identifying whether businesses were affected with the public interest. He argued that rate regulation of franchise corporations such as railroads and utilities could be constitutionally justified more easily than rate regulation of unincorporated or general manufacturing firms.[269] In fact, the power to regulate rates was inherent in the state's extension of monopoly grants or privileges, provided the state had reserved its right to amend the corporate charter. However, general business corporations that received "no franchise or privilege from the government" could be subjected to price regulation only if the corporations were "affected with the

262. Chicago, Burl. & Q.R.R. v. Iowa, 94 U.S. 155, 162 (1876).

263. *Id.*

264. Justice Field noted in a concurring opinion in Ruggles v. Illinois, 108 U.S. 526 (1883), that the *Munn* decision did "not relate to corporations." *Id.* at 541.

265. 94 U.S. 181 (1877).

266. *Id.* at 181-82.

267. WISC. CONST. art. XI, § 1 (1848).

268. *Stone*, 94 U.S. at 182-83. *See also* The Railroad Commission Cases, 116 U.S. 307, 347, 352 (1886) (holding that a charter giving the railroad the power to fix its rates nevertheless reserved to the legislature the power to determine their reasonableness).

269. 2 C. TIEDEMAN, *supra* note 208, at 974-75.

public interest."[270]

This distinction between general manufacturing and "franchise" or "quasi-public" corporations persists; franchise corporations today are an area of law distinct from general corporation law. In the third edition of his corporations treatise, published in 1894, William Cook included for the first time a large section on "quasi-public" corporations, which he characterized as not quite public but not quite private.[271] An entire treatise literature grew up in the early twentieth century on quasi-public, or "public service," companies.[272] In contrast to earlier single-industry treatises, such as Isaac Redfield's book on railroad law,[273] which dealt largely with tort and general corporate law, these treatises on public service corporations focused almost exclusively on their "regulatory" aspects. These aspects included the public service corporation's duty to provide universal service and adequate facilities as contemplated by its charter or state law, the legality of rate discrimination, and rate regulation. The "regulated industry" treatises said little about most general corporate law topics.

The move from charter-based to statute-based rate regulation made application of the due process clause to regulation inevitable. Rates established by charter were the product of an agreement between the state and stockholders, and the stockholders could always reject unacceptable offers. But statutory rate regulation was unilateral. The legislature might impose "confiscatory" rates or rates allowing less than a fair return. In an 1884 case, *Spring Valley Water v. Schottler*,[274] the Supreme Court first suggested that the due process clause might be used to strike down rate regulation if the "authorities do not exercise an honest judgment, or if they fix upon a price which is manifestly unreasonable."[275] Later, in *Smyth v. Ames*,[276] the Court condemned a state statute for denying regulated firms a fair return.[277] The transformation from charter-based to statute-based regulation took only two decades. It de-privatized the law of regulated industry by segregating the public utility from the general corporation, and in the process it removed one more distinction between chartered and unchartered business firms.

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270. *Id.* at 977.

271. 2 W. COOK, A TREATISE ON STOCK AND STOCKHOLDERS, BONDS, MORTGAGES, AND GENERAL CORPORATION LAW 1486 (3d ed. 1894).

272. *E.g.*, N. COLLIER, A TREATISE ON THE LAW OF PUBLIC SERVICE COMPANIES (1918); J. JOYCE, A TREATISE ON FRANCHISES (1909); O. POND, A TREATISE ON THE LAW OF PUBLIC UTILITIES (1913); R. WHITTEN, VALUATION OF PUBLIC SERVICE CORPORATIONS (2 vols. 1912); B. WYMAN, WYMAN ON PUBLIC SERVICE CORPORATIONS (2 vols. 1911).

273. I. REDFIELD, A PRACTICAL TREATISE ON THE LAW OF RAILROADS (1858).

274. 110 U.S. 347 (1884).

275. *Id.* at 354.

276. 169 U.S. 466 (1898).

277. *Id.* at 546-50.

IV. THE RISE OF THE GENERAL INCORPORATION ACT AND THE DECLINE OF THE SPECIAL SUBSIDY

Writing in the early nineteenth century, Thomas Cooper, the most Jeffersonian of America's political economists, minced no words about the American business corporation:

> [T]hese institutions are founded on the right claimed by government, to confer privileges and immunities on one class of citizens, not only not enjoyed by the rest, but at the expense of the rest. This is always done on the pretence of promoting the GENERAL WELFARE; a pretence of unlimited operation, and undefinable extent; and which has already rendered the constitution of the United States, a dead letter, and has actually converted our federal union into one despotic, consolidated government. . . .
>
> Generally in this country, it has glutted itself by incorporating banking companies, insurance companies, canal companies, and manufacturing companies of various descriptions. All these are increasing daily, the list of public nuisances.[278]

Characteristically Jeffersonian, Cooper responded to the Federalist corporation problem by attacking corporations on principle. Jacksonians, who were less agrarian and more entrepreneurial, chose instead to democratize the corporation to suit their purposes. General business corporation acts, which permitted firms to incorporate without seeking a special charter from the legislature, first became popular during the Jacksonian period.[279] Then came a broad attack on legislative and municipal subsidies as devices for encouraging economic development. The subsidies consisted of municipal stock subscriptions or grants of cash, often supported by the issuance of municipal bonds. Beginning in the Taney period, the Supreme Court decided some 300 cases challenging the validity of these bonds under a variety of theories.[280]

As J. Willard Hurst has observed, there is no evidence that Jacksonians were opposed to incorporation on principle. Rather, they were concerned about equal access and believed that the special charter system favored wealthy, well-established entrepreneurs at the expense of newcomers.[281]

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278. T. COOPER, LECTURES ON THE ELEMENTS OF POLITICAL ECONOMY 246 (2d ed. 1830).

279. For a chronological list of such acts, see Justice Brandeis's dissenting opinion in Liggett Co. v. Lee, 288 U.S. 517, 549 n.4 (1933).

280. T. FREYER, HARMONY & DISSONANCE: THE SWIFT & ERIE CASES IN AMERICAN FEDERALISM 60 (1981). For a review of these cases, see C. FAIRMAN, THE OLIVER WENDELL HOLMES DEVISE HISTORY OF THE SUPREME COURT OF THE UNITED STATES: RECONSTRUCTION AND REUNION: 1864-1888, at 918-1116 (1971); 3 C. WARREN, THE SUPREME COURT IN UNITED STATES HISTORY 74-75, 251 (1923); Powe, *Rehearsal for Substantive Due Process: The Municipal Bond Cases*, 53 TEX. L. REV. 738 (1975) (describing arguments used to challenge bond validity); Hovenkamp, *Federalism Revised* (Book Review), 34 HASTINGS L.J. 201, 210-12 (1982).

281. J.W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE

Even Jackson's outspoken opposition to reincorporation of the Second National Bank was based on his hatred of hard money and the National Bank's dominance over state banks rather than any general hostility toward the corporation as a method of doing business.[282] Indeed, one consequence of the general statute was a great increase in the number of business corporations. During the Jackson era the corporation became a democratic institution, consistent with the classical model of the business firm. Entry into corporate status became easier than entry into business itself.

The close connection between the rise of the general corporation act and the subsequent judicial revolt against the special subsidy is striking. Both developments flowed naturally from the classical theory of the corporation. Within the mercantilist model, the corporate structure was designed to protect enterprises regarded as otherwise potentially unprofitable. Special franchise privileges, freedom from competition, and direct subsidy were merely alternative ways of achieving the same result. For example, when the Federalist-controlled New York legislature began a comprehensive program to encourage industrial development at the beginning of the nineteenth century, it simultaneously used subsidies and special incorporation as incentives.[283]

Two decades later, the then-dominant Jeffersonian Republicans believed that the policy of "artificially" encouraging growth had gone too far and had become too political. They added a clause to the 1821 New York Constitution requiring a two-thirds vote of both houses of the legislature to appropriate "public moneys or property for local or private purposes" or to create or renew any corporate charter.[284] Jeffersonian, and later Jacksonian, opposition to business subsidies was certainly ideological, but it also may have been practical. An extraordinarily high number of public subsidies went to failed enterprises, such as canals, turnpikes, and railroads, and publicly financed loans had a high default rate.[285] The failures peaked during the 1837-1843 panic and inspired a great Jacksonian outcry against corporate subsidies.[286]

For the Jacksonian Democrats, opposition to subsidies and support of general incorporation acts were two edges of the same sword.[287] The 1846 New

UNITED STATES, 1780-1970, at 120 (1970). *See also* B. HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 405-10 (1957).

282. *See* J.W. HURST, *supra* note 281, at 116.

283. *See* R. SEAVOY, *supra* note 11, at 60-61.

284. N.Y. CONST., art. I, § 9 (1821) ("The assent of two-thirds of the members elected to each branch of the legislature shall be requisite to every bill appropriating the public moneys or property for local or private purposes, or creating, continuing, altering, or renewing, any body politic or corporate.").

285. *See* R. SEAVOY, *supra* note 11, at 177-80.

286. *See* L. HARTZ, ECONOMIC POLICY AND DEMOCRATIC THOUGHT 57 (1948); R. WIEBE, THE OPENING OF AMERICAN SOCIETY 245 (1984).

287. R. SEAVOY, *supra* note 11, at 180-85.

York Constitution, a Jacksonian document, replaced the two-thirds vote requirement with an outright prohibition against "the credit of the state" being "given or loaned to, or in aid of any individual, association, or corporation."[288] It replaced the two-thirds vote required for creating corporations—a relic of Jeffersonian hostility to business corporations in general—with a provision mandating general incorporation except where "the objects of the corporation cannot be attained under general laws."[289] Acting under this constitution, the New York legislature passed a series of general incorporation acts, each of which applied to a particular market, for example, one for roads and turnpikes, another for manufactures, another for railroads.[290]

The rise of general incorporation acts in the 1840s and 1850s rested on the premise that the corporation was no longer a "prerogative of the crown," requiring special permission and dedication to public use. A corollary was that subsidies for such corporations were no longer necessarily dedicated to a public use either. This set the stage for a general challenge to public subsidies on the grounds that they were politically motivated grants to favored, established entrepreneurs.

The many judicial decisions striking down such subsidies reflected a belief that they were designed, in the words of the Maine Supreme Court, "to load the tables of the few with bounty that the many may partake of the crumbs that fall therefrom."[291] In attacking subsidies, judges read into the constitutions a requirement that legislatures tax only for a "public use." First state courts,[292] and later federal courts,[293] held that corporate status did not determine whether an enterprise was engaged in a "public use." Rather, public use should be determined by the firm's activities. Under this rule, railroad

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288. N.Y. CONST. art. VII, § 9 (1846). In 1906, when James Gray wrote his treatise on the taxing power, virtually every state had a similar provision in its constitution. J. GRAY, LIMITATIONS OF THE TAXING POWER 140-57 (1906).

289. N.Y. CONST. art. VIII, § 1 (1846).

290. R. SEAVOY, *supra* note 11, at 191-92.

291. Opinion of the Justices, 58 Me. 590, 603 (1871).

292. *See, e.g.*, State *ex rel.* Burl. & Mission R.R. v. Wapello County, 13 Iowa 388, 404 (1862) (city may tax only to support public purpose); McConnell v. Hamm, 16 Kan. 228, 232-33 (1876) (bonds issued to subsidize wool mill void as issued for a purely private purpose); Ohio Valley Iron Works v. Moundsville, 11 W. Va. 1, 12-13 (1877) (bonds issued to support private ironworks void as subsidizing private enterprise). Important predecessor decisions upholding subsidies but suggesting that taxation not for a public purpose is unlawful are Sharpless v. Mayor of Philadelphia, 21 Pa. 147, 169 (1853) (upholding tax to benefit railroad; "the right to tax depends on the ultimate use, purpose, and object for which the fund is raised, and not on the nature or character of the person or corporation whose immediate agency is to be used in applying it"), and Goddin v. Crump, 35 Va. (8 Leigh) 120, 134-35 (1837) (acknowledging that test of legislative subsidy to corporation may be its probable public benefit but deferring to legislature to make this determination). See particularly Judge Brooke's dissent in *Goddin*, which may mark the first appearance of the "public purpose" doctrine. *Id.* at 152. Other cases are collected in C. JACOBS, LAW WRITERS AND THE COURTS chs. 4-5 (1953).

293. *See infra* text accompanying notes 295-98.

subsidies were generally upheld[294] while those for manufacturing were not.

The principal Supreme Court case was *Loan Association v. Topeka*,[295] decided in 1875. The Court struck down a statute authorizing a municipality to provide bonds for the construction of a privately owned, incorporated bridge works. The money raised was not a loan but rather a grant to the company. The Supreme Court held that a municipality could provide such a subsidy if it were financed with the income from municipally owned property, but since the subsidy came from taxes, the municipality had levied taxes for a private, rather than public purpose, which the federal Constitution forbade.[296] By the time the Court decided the *Topeka* case, however, it had approved state and local subsidies to railroad companies on numerous occasions,[297] on the theory that the railroad was a type of highway and that a municipality could build by means of a private corporation anything that it could build itself.[298]

The principal architects of the public purpose doctrine were two pioneers who had migrated to the Midwest during the Jacksonian era, Chief Justice Thomas M. Cooley of the Michigan Supreme Court and Judge John F. Dillon, first of the Iowa Supreme Court and later of the federal circuit court. Cooley, citing no authority, concluded in *Constitutional Limitations* that

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294. A few courts did strike down railroad subsidies. *See Burlington R.R.*, 13 Iowa at 423 (counties may not subsidize private railroads); People v. Salem, 20 Mich. 452, 489-93 (1870) (city may not tax to subsidize railroad; many private activities could also claim to be done for "public good" and would be difficult to distinguish); Whiting v. Sheboygan & F. du L.R.R., 25 Wis. 167, 184-85 (1869) (even railroad empowered with eminent domain authority must be treated as private corporation and state not allowed to subsidize). However states generally upheld such subsidies and the opinions striking them down came to be regarded as anomolies. *See* C. JACOBS, *supra* note 292, at 112-20; *see also* Mister, *Railroad Aid Bonds in the Supreme Court of the United States*, 17 AM. L. REG. (n.s.) 209 (1878) (criticizing Supreme Court decisions); Kent, *Municipal Subscriptions and Taxation in Aid of Railroads*, 9 AM. L. REG. (n.s.) 649 (1870) (arguing that courts overstepped authority in striking down railroad subsidies on constitutional grounds); S.T., *Municipal Subscriptions and Taxation in Aid of Railroads*, 9 AM. L. REG. (n.s.) 657 (1870) (arguing that benefit to railroad does not prevent railroad from being public benefit).

295. 87 U.S. (20 Wall.) 655 (1875); *see* City of Parkersburg v. Brown, 106 U.S. 487, 501 (1883) (manufacturing subsidy bonds held invalid under state law as taxation for private person); Cole v. City of La Grange, 113 U.S. 1, 6 (1885) (subsidy for iron company held improper taxation for benefit of private person).

296. *Topeka*, 87 U.S. (20 Wall.) at 664-65.

297. *E.g.*, Railroad Co. v. County of Otoe, 83 U.S. (16 Wall.) 667, 676 (1872) (legislature may authorize county aid to railroads outside county or even outside state, if purpose to give county desirable railroad connection); Mitchell v. Burlington, 71 U.S. (4 Wall.) 270, 273-74 (1866) (state may allow cities to tax to subsidize railroad as work of internal improvement); Rogers v. Burlington, 70 U.S. (3 Wall.) 654, 663-64 (1865) (power to borrow money for "any public purpose" authorizes municipality to issue bonds to aid railroad, which will provide public travel same as any highway).

298. *Rogers*, 70 U.S. (3 Wall.) at 665. The Court would continue to approve such subsidies in the future. *E.g.*, Quincy v. Jackson, 113 U.S. 332 (1885); Taylor v. Ypsilanti, 105 U.S. 60 (1881); Montclair v. Ramsdell, 107 U.S. 147 (1883); *see* Fallbrook Irrigation Dist. v. Bradley, 164 U.S. 112 (1896) (irrigation district is a public purpose).

"certain elements are essential in all taxation" and that, if one element were absent, citizens could challenge the tax on constitutional grounds "notwithstanding there be no conflict with constitutional provisions."[299] This extraordinary piece of mid-nineteenth century constitutional noninterpretivism was proposed in such an understated way that it even slipped by the Supreme Court. Justice Miller adopted Cooley's proposal in the *Topeka* case, citing Cooley, John Dillon's *Municipal Corporations,*[300] and one state case.[301] One "essential element," Cooley argued, is a "public purpose":

> [T]axation having for its legitimate object the raising of money for public purposes and the proper needs of government, the exaction of moneys from the citizens for other purposes is not a proper exercise of this power, and must therefore be unauthorized.[302]

John Dillon, who contributed more than anyone except Cooley to the constraints that late nineteenth century courts placed on state regulatory power,[303] was much more explicit than Cooley about the relationship between general incorporation and the public purpose doctrine. General incorporation acts, he argued, removed the corporation from the realm of public purpose. Public purpose must be determined from the nature of the activity rather than the corporate status of the persons engaged in it.[304]

In 1873 Judge Dillon wrote a circuit court opinion, later affirmed by the Supreme Court in one of *Topeka*'s companion cases.[305] Dillon's decision struck down the same Kansas statute at issue in *Topeka,* applied in this case to a municipal subsidy of a foundry and machine shop. Dillon found the prohibition against taxing to aid a private corporation in the general incorporation acts themselves. General corporation laws were "intended to correct an existing evil, and to inaugurate the policy of placing all corporations of the same kind upon a perfect equality as to all future grants of power" and to make "all judicial construction of their powers, or the restrictions imposed upon them, equally applicable to all corporations of the same class."[306] One of the objects of general corporation acts, Dillon concluded, "was to cut up by the roots the mischief of special legislation, particularly in respect to cor-

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299. T. COOLEY, *supra* note 162, at 487.

300. J. DILLON, TREATISE ON THE LAW OF MUNICIPAL CORPORATIONS (1872).

301. *Topeka,* 87 U.S. (20 Wall.) at 663.

302. T. COOLEY, *supra* note 162, at 487.

303. *See* C. JACOBS, *supra* note 209, at 121 (1954) (with exception of Cooley, Dillon authority cited most often for public purpose restriction).

304. J. DILLON, *supra* note 300, at 70-75.

305. Commercial Nat'l Bank v. Iola, 6 F. Cas. 221 (D. Kan. 1873) (No. 3,061), *aff'd,* 22 L.Ed. 463 (1875). The decision was affirmed with a short opinion on the same day as *Topeka,* but was inadvertently omitted from the U.S. Reports.

306. 6 F. Cas. at 222 (quoting Atkinson v. Marietta & C.R.R., 15 Ohio St. 21 (1864)).

porations, both public and private."[307] However, subsidies by their nature selected a few for special treatment, without consideration in return. The proprietors of a general manufacturing corporation, unlike the shareholders in a franchise or public service company, "are under no obligations, by reason of the aid extended and the burden of taxation thereby imposed upon the municipality, to render it or the state any duty or service whatever—not even to repay the loan, or to maintain for any specified time the contemplated manufacturing enterpise."[308]

Three years later, the New York Court of Appeals applied this reasoning in striking down a municipal subsidy to a lumber mill.[309] The court noted that the corporation had been created under a general incorporation law, and therefore no presumption existed that its activities were for a public purpose:

> It must be plain that there is nothing in the fact of this body being a corporation that brings any factor into the problem. Any individual, or partnership of individuals, with the requisite capital, could do all that this corporation proposed to do, or had corporate power or privilege to do, and with the same results to the public.[310]

Dillon's argument that the general manufacturing company provided no "consideration" for its subsidy explained why subsidies to railroads were routinely upheld. Municipalities competed with one another for railroad depots, and the subsidies were conditioned on the railroad building a terminal or laying tracks through or near the municipality.[311] Thus the railroad performed a "public" service, bringing it within the municipal taxing power. Although today municipalities might compete with one another for manufacturing businesses,[312] within the classical model of political economy such competition must be left to the market alone.

307. *Id.* at 222-23.

308. *Id.* at 223. In some of the public purpose cases not involving railroads, the grants were conditioned on recipients actually constructing a particular project and operating it for a specified minimum time. *E.g.*, Allen v. Inhabitants of Jay, 60 Me. 124, 126 (1872) (condition of subsidy was that grantees erect sawmill, gristmill, and box factory in town and operate them at least ten years).

309. Weismer v. Village of Douglas, 64 N.Y. 91, 106 (1876).

310. *Id.* at 101.

311. For example, the bonds issued in Railroad Co. v. County of Otoe, 83 U.S. (16 Wall.) 667, 669-70 (1872), were conditioned on the railroad's establishment of a connection in Nebraska City, Nebraska. *See also* Green v. Dyersburg, 10 F. Cas. 1099, 1100 (W.D. Tenn. 1879) (No. 5,756) (bond authorization made subject to condition "that the said railroad shall be contructed to the town of Dyersburg, Tennessee, and have a depot of said railroad located within half a mile of the court house in said town").

312. *See* Poletown Neighborhood Council v. City of Detroit, 410 Mich. 616, 633-34, 304 N.W.2d 455, 459-60 (1981) (finding that a municipality's condemnation of land for resale to automobile manufacturer was for "public use," and thus constitutional). *Topeka* was virtually overruled by the Supreme Court in Green v. Frazier, 253 U.S. 233 (1920), which simply noted that some purposes formerly regarded as "private" were now seen by legislatures to be public, and the Court would defer to that judgment. *Id.* at 242-43.

From the onset, courts had a difficult time locating the line between private and public purposes.[313] A consensus emerged that "public purpose" in taxation law meant the same thing as "public purpose" in eminent domain law,[314] since both involved a forced transfer of property from one person to another. This solution was circular, however, because the exercise of eminent domain was proper only if for a "public purpose." Nevertheless, several courts held that the government could grant subsidies to corporations that had the power of eminent domain, but not to others.[315] Since the power of eminent domain was a prerogative of the crown, only corporations could exercise it, and only if their charters so provided. Thus, corporate status became a prerequisite to direct government subsidies, although such status alone was not sufficient.

This distinction widened the growing gap between utilities, or public service corporations, and general corporations.[316] In his 1909 treatise on franchises, Joseph Joyce noted the great ambiguity in the use of the term "franchise" and devoted two chapters to its definition.[317] While all corporations technically received a "franchise" from the state, the "franchise" accorded a public service corporation was qualitatively different from the general corporate franchise. Joyce concluded that while the corporate charter was a franchise from the state, a particular charter also might contain other franchises that distinguished it from general corporations.[318] These "special" franchises justified more intensive state regulation than was appropriate for the ordinary manufacturing firm.[319]

V. THE CONSTITUTIONAL "PERSONHOOD" OF CORPORATIONS

The idea that a corporation is a "person" for legal purposes is one of the most misunderstood doctrines in American legal history. By the end of the century, the doctrine had given the corporation an almost metaphysical qual-

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313. *See* Township of Burlington v. Beasley, 94 U.S. 310, 314 (1876) (bonds for construction of steam-driven gristmill were for public purpose). In Jarrott v. Moberly, 13 F. Cas. 366 (C.C.W.D. Mo. 1878) (No. 7,223), *aff'd*, 103 U.S. 580 (1880), Judge Dillon held that municipal bonds issued to a railroad company for construction of a machine shop were for a "public use," since operation of the machine shop was essential to operation of the railroad. *Id.* at 367. However, he then found the bond issue invalid under state law. *Id.* at 367-68.

314. *See* Stewart v. Supervisors of Polk County, 30 Iowa 9, 27 (1870) (upholding tax for railroad construction as public use, as defined by eminent domain law); Sharpless v. Mayor of Philadelphia, 21 Pa. 147, 167 (1853) (upholding act authorizing subscription of railroad stock by city as creating public debt, as defined by eminent domain law); *see generally* J. GRAY, *supra* note 288, at 129-32 (comparing eminent domain and taxation "public purpose" doctrines).

315. *See* T. COOLEY, A TREATISE ON THE LAW OF TAXATION 77 n.1 (1876).

316. On the emergence of the concept of the regulated firm, see *supra* Part III.

317. J. JOYCE, *supra* note 272, chs. 1 & 2.

318. *Id.* at 11.

319. *Id.* at 7.

ity, a creation of the law yet so much a "person" that it even had constitutional rights.

The constitutional doctrine of "personhood" was the Supreme Court's solution to two problems. The first problem was guaranteeing that the owners of property held in the name of a corporation would receive the same constitutional protections as the owners of property held in their own name. The second problem, which lies below the surface, was how to assign the power to assert constitutional rights in corporately held property. The doctrine that a corporation is a constitutional person meant that the corporation's directors or managers could assert its constitutional claims. The less-cited corollary was that shareholders lacked standing to assert the corporation's constitutional rights, just as they lacked standing to represent the corporation in most legal disputes. Had the doctrine of corporate constitutional personhood not been developed, corporate property still would have been protected by the fourteenth amendment. Shareholders, rather than the corporation, would have been allowed to assert claims for unconstitutional injuries. Thus the Supreme Court's decisions that a corporation is a constitutional "person" were an important step in the separation of ownership from control that characterized the classical corporation.

A. DOMESTIC CORPORATIONS AND THE FOURTEENTH AMENDMENT

The classical business corporation provided a means for managing capital and investment, not a privilege from the state. But the corporation did not lose all state protection. On the contrary, it became entitled to the same protections accorded any person in business. The decline of contract clause jurisprudence and the gradual replacement of "vested" rights with "substantive" rights reflected the Supreme Court's rejection of a set of protections unique to corporations as a class, or rather, unique to individual corporations. In their place developed a set of protections shared by all forms of business organization.

Key to this development was the notion that a corporation is a "person" within the meaning of the fourteenth amendment and is entitled to many of the protections that the fourteenth amendment accords natural persons, including liberty of contract,[320] equal protection,[321] and eventually just compensation for takings.[322] This doctrine of corporate constitutional personhood reflected the developing judicial principle that the corporation

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320. *See infra* text accompanying notes 350-73.

321. *See* Santa Clara County v. Southern Pac. R.R., 118 U.S. 394, 396 (1886) (refusing to hear argument on whether corporations are persons within the meaning of the equal protection clause since corporations obviously are covered).

322. *See* Chicago, Burlington & Quincy R.R. v. Chicago, 166 U.S. 226, 241 (1897) (taking property without just compensation violates company's fourteenth amendment right of due process).

and sole proprietorship are merely alternative forms of business organization. For most constitutional purposes, they should be treated the same. As Justice Field noted in his concurring opinion in *San Bernardino County v. Southern Pacific Railroad,* "nearly all great enterprises are conducted by corporations."[323] Therefore, the Court needed to determine "whether corporate property is subject to the same rules of assessment and taxation as like property of natural persons, or whether elements which affect the valuation of property are to be omitted from consideration when it is owned by them."[324]

In *Santa Clara County v. Southern Pacific Railroad,*[325] the Supreme Court first suggested that a corporation is a "person" within the meaning of the fourteenth amendment, noting that it found the issue too obvious for argument.[326] In *Pembina Consolidated Siver Mining and Milling Co. v. Pennsylvania*[327] the Court gave its reasons:

> Such corporations are merely associations of individuals united for a special purpose, and permitted to do business under a particular name, and have a succession of members without dissolution. As said by Chief Justice Marshall, "The great object of a corporation is to bestow the character and properties of individuality on a collective and changing body of men." Providence Bank v. Billings, 4 Pet. 514, 562. The equal protection of the laws which these bodies may claim is only such as is accorded to similar associations within the jurisdiction of the State.[328]

As Morton J. Horwitz has argued, *Santa Clara* does not represent the Supreme Court's rejection of older "associational" or "fictional" theories of the corporation in favor of an "entity" theory that imputed a great deal of personhood to the corporation itself.[329] On the contrary, the Court relied explicitly on the idea that a corporation is an association of individuals. Its interests are identical to those of its shareholders. As a result, it should receive the same protections granted to any partnership or sole proprietorship.[330]

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323. 118 U.S. 417, 422-23 (1886) (Field, J., concurring).

324. *Id.*

325. 118 U.S. 394 (1886).

326. *Id.* at 396; *see also* Insurance Co. v. Morse, 87 U.S. (20 Wall.) 445, 455-58 (1874) (striking down a Wisconsin anti-removal statute applied to a corporation; corporations are "citizens" with a constitutionally protected right of access to the federal courts). For the background of the *Santa Clara* decision, see Flynn, *The Jurisprudence of Corporate Personhood: the Misuse of a Legal Concept,* in CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY 131 (W. Samuels & A. Miller eds. 1987); Graham, *An Innocent Abroad: the Constitutional Corporate "Person,"* 2 UCLA L. REV. 155 (1955).

327. 125 U.S. 181 (1888).

328. *Id.* at 189; *see also* Missouri Pacific R.R. v. Nebraska, 164 U.S. 403, 417 (1896) (holding that the takings clause applies to corporations).

329. Horwitz, *Santa Clara Revisited: the Development of Corporate Theory,* 88 W. VA. L. REV. 173, 223 (1985).

330. *Id.* at 174.

The best explanation of *Santa Clara* is that by 1886 both state and federal courts agreed that, in most cases, the corporation, rather than its shareholders, must be the named party to the corporation's litigation.[331] Shareholders lacked standing to redress the corporation's grievances. The corporation owned real property, transacted business, and dealt with the government in its own name. Thus, even though the purpose of *Santa Clara* was to protect shareholders' constitutional rights, the most consistent and practical way to achieve this was to declare the corporation a "person" for constitutional purposes. Importantly, there also was precedent involving corporate "citizenship" for diversity purposes. The logical step from declaring corporations to be constitutional "citizens" to finding them constitutional "persons" was not large, particularly in an era when the coverage of the fourteenth amendment was relatively insubstantial. The Court had refused to apply due process analysis in cases involving corporate regulation.[332] In 1886, the same year that *Santa Clara* was decided, the Supreme Court first struck down a statute under the equal protection clause;[333] but two years later the Court made clear that the standard for upholding a statute against such a challenge was not high.[334] Selective incorporation of the Bill of Rights did not begin for another decade.[335] Only thirty or forty years of hindsight can attach great consequences to the substantive protections produced by the *Santa Clara* decision.

The Court might have chosen another route for giving what little fourteenth amendment protection existed to private property owned by corporations. It might have said that the corporation represents the constitutional property rights of its shareholders. But that would have left the Court in a quagmire concerning one person's right to assert the constitutional claims of another. Worse, it might have opened the door to shareholder participation in constitutional litigation involving the corporation, since the shareholders' rights were at stake. The thought that every shareholder could challenge a rate regulation as confiscatory would make any federal judge shudder. One

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331. *See, e.g.*, Henry v. Elder, 63 Ga. 347, 348-49 (1879) (stockholder has no standing to enjoin foreclosure sale of corporate property); Blackman v. Central R.R., 58 Ga. 189, 190 (1877) (stockholders cannot defend a suit against a corporation); Heath v. Ellis, 66 Mass. (12 Cush.) 601, 604 (1853) (stockholders must sue the corporation on behalf of all stockholders); Silk Mfg. Co. v. Campbell, 27 N.J.L. 539, 541 (1859) (individual cannot bring suit in name of corporation without consent of corporation).

332. Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 81 (1873); *see* Railroad Commission Cases, 116 U.S. 307, 331 (1886) (upholding rate regulation but warning that the Court might apply due process clause to regulations that force firms to accept unremunerative returns).

333. Yick Wo v. Hopkins, 118 U.S. 356, 373 (1886) (purported safety ordinance unconstitutionally discriminated against Chinese Americans).

334. Powell v. Pennsylvania, 127 U.S. 678, 684-85 (1888) (presumption that statute is valid).

335. The first incorporation decision was Chicago, Burl. & Q.R.R. v. Chicago, 160 U.S. 226 (1897), applying the fifth amendment takings clause to states.

corollary of the *Santa Clara* decision was that since a corporation could assert constitutional rights respecting property to which it held title, its shareholders lacked standing to assert those same rights. It took the Supreme Court two decades to develop this consequence of *Santa Clara.*

The Supreme Court did find shareholder standing in cases asserting the constitutional rights of corporations when the suits were brought as shareholder derivative actions. For example, in *Pollock v. Farmers' Loan & Trust Co.*[336] the stockholders sought to enjoin their corporation from paying federal income tax, which they successfully alleged to be unconstitutional.[337] The Court relied on *Dodge v. Woolsey,*[338] in which the Supreme Court had accepted the principle of the shareholder derivative suit, to hold that the shareholders had standing to sue their own corporation in equity "to prevent any threatened breach of trust in the misapplication or diversion of the funds of a corporation by illegal payments out of its capital."[339] Likewise, in *Smyth v. Ames*[340] the Court permitted a stockholder suit which alleged that a rate statute was unconstitutional and which sought to enjoin the corporations from charging the illegal rates.[341] The Court again treated the suit as a derivative action and noted that multiple stockholder suits would not pose a problem because the decree would bind all the stockholders in this class action proceeding, as well as the corporation.[342]

The implications of *Santa Clara* for shareholder suits challenging the constitutionality of statutes became clear in the 1903 case *Corbus v. Alaska Treadwell Gold Mining Co.*[343] A shareholder had sued his corporation to restrain it from paying a state license tax alleged to be unconstitutional. The Supreme Court dismissed the complaint, holding that only the corporation was the proper party to bring suit. The Court noted that "[t]he directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all."[344] The presumption could be defeated in a derivative suit, but here the plaintiff had failed to make demand on the directors "to protect the corporation against this alleged illegal tax."[345] As a result, the corporation, not its shareholders, was the appropri-

336. 157 U.S. 429 (1895).
337. *Id.* at 433.
338. 59 U.S. (18 How.) 331 (1856).
339. *Pollock,* 157 U.S. at 553; *see also* Hawes v. Oakland, 104 U.S. 450, 460-61 (1881) (detailing requirements for shareholder derivative suits in federal court). Later cases developing the shareholder derivative suit include Huntington v. Palmer, 104 U.S. 482 (1882), City of Quincy v. Steel, 120 U.S. 209 (1884), and Dimpfel v. Ohio & Mississippi Rwy., 110 U.S. 209 (1884).
340. 169 U.S. 466 (1898).
341. *Id.* at 517.
342. *Id.* at 517-18.
343. 187 U.S. 455 (1903).
344. *Id.* at 463.
345. *Id.* at 465.

ate party to protect its fourteenth amendment rights. The same year, the Supreme Court required shareholder suits asserting the constitutional claims of the corporation to meet the requirements for derivative actions, including "an allegation that the directors of a corporation have refused to institute the proceedings themselves in the name of such corporation."[346] Subsequently, the Court routinely entertained shareholder challenges to the unconstitutionality of legislation, provided that the actions were cast as derivative suits and the corporation itself was named as a defendant.[347] In the first instance however, the obligation to assert the corporation's constitutional rights lay with the directors.

In retrospect, it appears the Court selected the shortest and most practical route to its end, constitutional protection of shareholder property rights equivalent to the protection given to unincorporated firms or persons. Nevertheless, the Progressive critique of Gilded Age corporate law described *Santa Clara* and its progeny as "big business" decisions by a reactionary Supreme Court. For example, John R. Commons' 1924 *Legal Foundations of Capitalism*[348] blamed the Court's hostility toward labor unions for the decision that a corporation is a legal "person." As a result of the decision, Commons complained, laborers acting together in an unincorporated labor union constituted a "conspiracy," while a union of capitalists joined in a business corporation comprised a single entity incapable of conspiring.[349] But clearly, neither *Santa Clara* nor *Pembina* expressed any Supreme Court bias in favor of big business at the time they were decided. On the contrary, they were eminently Jacksonian decisions, representing the constitutional merger of the business corporation into ordinary enterprise. Although *Santa Clara* and *Pembina* were decided more than a decade before the Supreme Court formally adopted substantive due process, they gave corporations the same freedom from state regulation that liberty of contract and substantive due process provided unincorporated businesses. Corporate status, once again, had become irrelevant.

But there is one important difference between the natural person's right to contract and the corporation's right: the corporation has only those powers granted to it by the sovereign. Already in 1880, a Maryland court held that while a legislature may not forbid natural persons from paying non-cash wages, it could do so to corporate employers, as long as the state had re-

346. Davis & Farnum Mfg. Co. v. Los Angeles, 189 U.S. 207, 220 (1903) (citing *Dodge v. Woolsey*).

347. *See Ex Parte* Young, 209 U.S. 123, 143 (1908) (stockholder in railroad can sue to enjoin directors and officers from complying with potentially unconstitutional state statute when railroad properly named as defendant in complaint).

348. J. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM (1924).

349. *Id.* at 296-97 (1924); *see* Hovenkamp, *Labor Conspiracies in American Law*, 66 TEX. L. REV. 919, 958-962 (1988) (discussing problem of labor unions and incorporation).

tained the power to amend the corporate charter.[350] "A corporation has no inherent or natural rights like a citizen. It has no rights but those which are expressly conferred upon it, or are necessarily inferrible from the powers actually granted, or such as may be indispensible to the exercise of such as are granted."[351]

In the wake of *Santa Clara* and *Pembina* several state courts concluded that, general applicability of the fourteenth amendment notwithstanding, liberty of contract was a liberty unique to people. "Natural persons do not derive the right to contract from the legislature. Corporations do," the Arkansas Supreme Court concluded in 1894.[352] While legislatures lacked the power to dictate how natural persons paid their employees, they could do so with corporate employers.[353] Likewise, in 1892 a Rhode Island court upheld a statute requiring corporate employers to pay employees weekly, noting that the statute would be unconstitutional if applied to natural persons. Corporations, it said, stood on a different footing:

> But for the power granted by the legislature, corporations could not make any contract, and we see no reason why the legislature, under its reserved power to amend charters, cannot limit the power to contract in the future just as they might have fixed it in the original charter, if any reasonable purpose is to be subserved thereby.[354]

The Rhode Island court did note that the statute abridged the liberty of contract of the employees, who were natural persons. But it concluded that since "corporations are artificial bodies and possess only such powers as are granted to them," it follows that "natural persons dealing with them have no right to demand that greater power should be granted to corporations in order that they may make other contracts with such corporations than the corporations are authorized to enter into."[355]

Similarly in 1903, the Maine Supreme Court held that a general reservation clause permitting the state to amend a corporate charter lawfully de-

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350. Shaffer & Munn v. Union Mining Co., 55 Md. 74, 79 (1880).

351. *Id.*; *see* City of Roxbury v. Boston & Providence R.R., 60 Mass. (6 Cush.) 424, 433 (1850) (holding pre-charter statute allowing the legislature to amend railroad charters justified a later statute dictating where railroad bridges must be built over traffic crossings).

352. Leep v. Railway Co., 58 Ark. 407, 427, 25 S.W. 75, 81 (1894).

353. *Id.* at 427-28, 25 S.W. at 81.

354. State v. Brown & Sharpe Mfg. Co., 18 R.I. 16, 35, 25 A. 246, 253 (1892); *see* Lawrence v. Rutland R.R., 80 Vt. 370, 376-77, 67 A. 1091, 1092 (1907) (law requiring manufacturing businesses and utilities to pay wages in cash weekly within scope of state's reserved power to amend charters); State v. Peel Splint Coal Co., 36 W. Va. 802, 814-28, 15 S.E. 1000, 1005-09 (1892) (laws requiring payment of wages in cash and weighing of coal where mined within scope of state's reserved power to amend charters). *But see* State v. Missouri Tie & Timber Co., 181 Mo. 536, 562-63, 80 S.W.2d 933, 941-42 (1904) (act making it a misdemeanor to pay non-cash wages violates liberty of contract of both corporations and natural persons).

355. *Brown & Sharpe,* 18 R.I. at 37, 25 A. at 253.

prived a corporation of the right to challenge state regulatory statutes on liberty of contract grounds.[356] The state concluded that the legislature:

> can prohibit the acquisition of any more property by the corporation. It can prohibit the making of any new contract whatever by the corporation, or any new contract except one of a particular prescribed kind and form. . . . This power, sweeping as it is in scope, is necessarily implied and included in the reserved power to amend, alter, or repeal [the corporate charter]. This power is inherent in the legislature, unlimited by any section or clause in the federal or state constitutions which we have been able to find.[357]

There was important Supreme Court precedent for this view. In *Bank of Augusta v. Earle*[358] the Court, speaking through Chief Justice Taney, had held that corporations of one state could do business in another state, subject to that state's permission and regulation.[359] In reaching that result, Taney explicitly rejected the notion that a corporation has the same power to contract as a stockholder. The issue was the privileges and immunities clause, not the fourteenth amendment, but the conclusions were broad enough to apply to both. Taney conceded that the Court's earlier *Deveaux* decision,[360] making a corporation a "citizen" for diversity jurisidiction purposes, had ascribed a certain amount of personhood to the corporation. However, he rejected application of *Deveaux,* stating that the "principle has never been extended any farther than it was carried in that case, and has never been supposed to extend to *contracts* made by a corporation."[361] The question of state-imposed limitations on the power to contract rested on a different footing, Taney concluded. Such limitations followed from corporations' limited liability. If corporations:

> were to be regarded as individuals carrying on business in their corporate name, and therefore entitled to the privileges of citizens in matters of contract, it is very clear that they must at the same time take upon themselves the liabilities of citizens, and be bound by their contracts in like manner.[362]

The result, of course, was that the corporation would become "a mere partnership in business," something the shareholders did not want. Under that reasoning, the corporation would have acquired no *distinct* liberty of contract under the fourteenth amendment. It would have been subject to the

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356. *In re* Opinion of the Justices, 97 Me. 590, 593, 55 A. 828, 829 (1903).

357. *Id.*

358. 38 U.S. (13 Pet.) 519 (1839).

359. *Id.* at 586-89.

360. Bank of the United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809).

361. *Bank of Augusta*, 38 U.S. (13 Pet.) at 586 (emphasis added).

362. Chief Justice Taney noted that under such an agreement "each stockholder would be liable to the whole extent of his property for the debts of the corporation" and he could be subject to suit in any state. *Id.*

legislature's power to control its corporate charters, personhood notwithstanding. Taney concluded:

> Whenever a corporation makes a contract, it is the contract of the legal entity; of the artificial being created by the charter; and not the contract of the individual memebers. The only rights it can claim are the rights which are given to it in that character, and not the rights which belong to its members as citizens of a state . . . .[363]

All this state and federal precedent notwithstanding, the Supreme Court applied the liberty of contract in favor of a corporation in *Allgeyer v. Louisiana*,[364] its first substantive due process decision, with no mention of any difference between natural persons and corporations.[365] To be sure, *Allgeyer* may not be precisely on point. Like *Bank of Augusta*, it involved application of a state statute to a corporation created in a different state. Although a state might control its own corporate charters, it could not generally control those granted by other states. However in *Coppage v. Kansas*,[366] which struck down a labor statute applied against a domestic corporation on liberty of contract grounds, the Court again failed to consider whether a corporation's liberty of contract right might be inferior to that of a natural person.[367] In *Chicago, Burlington & Quincy Railroad Co. v. McGuire*,[368] the Court upheld a regulatory statute applied to a corporation against a liberty of contract challenge.[369] The Court listed several reasons why the statute was within the state's police power and, therefore, did not interfere with the plaintiff's freedom of contract, but the plaintiff's corporate status was not among them.[370] The closest the Supreme Court came to dealing with the issue was *Atkin v. Kansas*,[371] upholding an eight-hour law that applied only to state and municipal employees.[372] The Court found that the state's ability to control a public corporation, in this case a municipality, justified the statute. The powers of a state's public corporations "may be restricted or enlarged, or altogether withdrawn at the will of the legislature."[373]

In the fourteenth amendment cases, the Supreme Court was protecting the constitutional rights of shareholders, to whom liberty of contract clearly applied. *Bank of Augusta* offered no precedent limiting their rights. Neverthe-

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363. *Id.* at 587.
364. 165 U.S. 578 (1897).
365. *Id.* at 590-593.
366. 236 U.S. 1 (1915). The case followed Adair v. United States, 208 U.S. 161, 179 (1908), which struck down a federal labor statute applied to a state-chartered corporation.
367. 236 U.S. at 21-24.
368. 219 U.S. 549 (1911).
369. *Id.* at 574-75.
370. *Id.* at 566-568.
371. 191 U.S. 207 (1903).
372. *Id.* at 224.
373. *Id.* at 221.

less, the Supreme Court's failure in the due process cases to consider state power over corporate charters is troublesome and seems inconsistent with its contract clause jurisprudence of the same era, where it interpreted state reservations expansively. It seems equally inconsistent with the Supreme Court's continual use of the doctrine of ultra vires to undermine contracts which were beyond the corporation's power to make.

But this triumph of the corporation's liberty of contract was an important federal consitutional recognition of the classical corporation, all the more important because the arguments against the doctrine were persuasive, well-established in state decisions, and so thoroughly ignored by the Supreme Court. For the Court to hold otherwise would have been to create a regime in which the state could freely regulate wages, hours, and working conditions of corporate employers but not of unincorporated ones. Such a distinction would have undermined the classical view of the general business corporation as nothing more than an efficient device for raising capital and doing business. At bottom, the corporate personhood doctrine of *Santa Clara* represented an efficient way for the corporation to assert the property rights of its shareholders.

B. FOREIGN CORPORATIONS

Section one of the fourteenth amendment uses the word "person" three times. The first use defines citizens of the United States as "persons born or naturalized in the United States."[374] The second provides that a state may not deprive a person of life, liberty, or property, without due process of law. The third provides that a state may not deny the equal protection of laws to any "person within its jurisdiction." Eventually the Supreme Court came to hold that a foreign firm, that is, a firm incorporated in one state but doing business in a different state, is a "person within the jurisdiction" of the second state.[375]

In *Bank of Augusta,* the Supreme Court held that a state could more-or-less arbitrarily exclude foreign corporations from doing business within its territory.[376] Under that rule the Supreme Court upheld discriminatory taxes against foreign corporations as late as the 1870s and 1880s.[377] The cases established that a corporation is not a "citizen" for purposes of the privileges and immunities clause, which controlled discrimination by one state against

374. U.S. CONST. amend. XIV, § 1.

375. Western Union Tel. Co. v. Kansas, 216 U.S. 1, 26-27 (1910).

376. *Bank of Augusta,* 38 U.S. (13 Pet.) at 587-89 (1839).

377. *See* Philadelphia Fire Ass'n v. New York, 119 U.S. 110, 148 (1886) (upholding corporate franchise tax on capital stock of corporation); Ducat v. Chicago, 77 U.S. (10 Wall.) 410, 415 (1870) (upholding bond requirement for out-of-state companies); Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1868) (upholding bond requirement for out-of-state insurance companies).

citizens of another state.[378] *Pembina Mining Co. v. Pennsylvania*[379] reiterated this new holding that a corporation was a "person" under the fourteenth amendment but not a "citizen" under the privileges and immunities clause.[380] As a result, although a state could not unreasonably discriminate on the basis of corporate status or take away corporate property without paying just compensation,[381] the prohibition against discrimination on the basis of citizenship did not apply to corporations.

While *Pembina* reiterated the *Bank of Augusta* doctrine, that doctrine had already begun to unravel in a series of "unconstitutional conditions" cases. In 1874 Justice Bradley wrote in a dissenting opinion that although a state might prohibit all foreign corporations from doing business within its borders, "it has no power to impose unconstitutional conditions upon their doing so."[382] In the unconstitutional conditions cases,[383] *Allgeyer v. Louisiana,*[384] and a series of cases striking down discriminatory taxes under the commerce clause,[385] the Court gradually recognized the right of corporations to work in multistate markets. This development culminated in a series of decisions in the first two decades of the twentieth century holding that a foreign corporation is a "person within the jurisdiction" of a state in which it is doing business, and can not be expelled arbitrarily.[386] These cases, which carried the "personhood" of the corporation much further than Taney and other early Jacksonians had been willing to do, deliberately put the corporation doing interstate business on the same constitutional footing as the natural person.

But the multistate corporation proved a powerful and unruly mount, often beyond any state's ability to control. The corporation's expanded rights to

378. *E.g., Paul,* 75 U.S. (8 Wall.) at 177-82.

379. 125 U.S. 181 (1888).

380. *Id.* at 187.

381. The Supreme Court incorporated the takings clause and applied it to corporations in Chicago, Burlington & Quincy R.R. Co. v. Chicago, 166 U.S. 226 (1897).

382. Doyle v. Continental Ins. Co., 94 U.S. 535, 543 (1874) (Bradley, J., dissenting).

383. *See* Barrow Steamship Co. v. Kane, 170 U.S. 100, 111 (1898) (holding unconstitutional a statute requiring corporation as a condition precedent to doing business to agree not to seek removal of any case brought in a state court to a federal court); Martin v. Baltimore and Ohio R.R., 151 U.S. 673, 684 (1894) (same); Southern Pac. Co. v. Denton, 146 U.S. 202, 207 (1892) (same).

384. 165 U.S. 578, 591 (1897) (recognizing that liberty of contract protected the right of citizens of one state to do business with corporations in another state).

385. One of the first cases to strike down a discriminatory tax was Welton v. Missouri, 91 U.S. 275, 282 (1875), which held that a tax on sellers of goods produced out-of-state was a violation of commerce clause. *See generally,* G. HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 112-31 (1918) (examining cases establishing rights of foreign corporations under commerce clause); McCurdy, *American Law and the Marketing Structure of the Large Corporation, 1875-1890,* 38 J. ECON. HIST. 631 (1978) (reviewing development of right of foreign corporations to compete in multistate markets).

386. Western Union Tel. Co. v. Kansas, 216 U.S. 1, 21 (1910); Ludwig v. Western Union Tel. Co., 216 U.S. 146, 159-60 (1910); Southern Ry. v. Greene, 216 U.S. 400, 412-13 (1910).

engage in multistate business contributed to the rise of the "trust" and the perceived concentration of business that were to spell the demise of the classical corporation.

VI. LIMITED SHAREHOLDER LIABILITY

Modern limited liability means that as a general rule shareholders are not accountable for debts or other claims against the corporation beyond the extent of their investment in shares. English common law recognized limited liability for shareholders and an 1825 English statute codified the common law.[387] Limited liability has been recognized in the United States at least since the eighteenth century.[388] In 1832, Angell and Ames concluded that "[n]o rule of law . . . is better settled, than that, in general, the individual members of a private corporate body are not liable for the debts, either in their persons or in their property, beyond the amount of property which they have in the stock."[389] They later noted that some state statutes did increase shareholder liability beyond the common law rule.[390]

The voluminous writings on the history of American corporate law have not adequately explained either the evolution of limited liability in the nineteenth century or its meaning. Morton Horwitz regards the modern concept of relatively strict limited liability as a late nineteenth century phenomenon.[391] But ample evidence suggests that it grew up during the Jackson era and was part of the classical theory of the corporation. Connecticut, New Hampshire, Maine, Vermont, Rhode Island, New Jersey and Pennsylvania had adopted limited liability statutes during the second and third decades of the nineteenth century.[392]

But before its acceptance, the doctrine of limited liability engendered much hostility. During the first third of the nineteenth century, American states experienced a general legislative and judicial reaction against limited liability. Jeffersonians, who typically were not favorably inclined toward

387. 6 Geo. 4, ch. 91 (1825). The statute provided for limited liability unless a charter expressly stated otherwise.

388. *See* 1 J. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 447 (quoting an article that appeared in the Gazette of the United States, Sept. 22, 1792, at 2, col. 1, which argued that limited liability explained popularity of incorporation); 2 *id.* at 317 (suggesting that limited liability was the principal reason for bank incorporation in the late eighteenth century). At least one manufacturing firm received a specific grant of limited liability in its charter in 1786. *See id.* at 260 (charter of the Associated Manufacturing Iron Company of the City and County of New York granted limited liability); *id.* at 267-68 (describing the 1789 charter of the Baltimore Manufacturing Company, providing for limited liability only after subscriptions were fully paid).

389. J. ANGELL & S. AMES, *supra* note 5, at 349.

390. *Id.* at 357.

391. *See* Horwitz, *supra* note 329, at 208-09 (pointing out that liability was imposed under "double liability" statutes and the Trust Fund doctrine as late as 1900).

392. E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 387-451 (1954).

business corporations, appear to have regarded limited liability as one of the many political favors granted to wealthy entrepreneurs. For example, Jeffersonian political economist Thomas Cooper characterized limited liability as a "mode of swindling, quite common and honourable in these United States"[393] and "a fraud on the honest and confiding part of the public."[394] But the Federalists also had a narrower concert of limited liability than the later Jacksonians, as reflected by the Massachusetts experience.

Massachusetts, for a time, provided *unlimited* liability of shareholders. But the Massachusetts approach, about which the most has been written,[395] is atypical and reflective of the weakness of the state's Jacksonian movement.[396] Some Massachusetts charters granted to manufacturing corporations during the early nineteenth century provided for unlimited liability,[397] and an 1809 Massachusetts statute which applied to all manufacturing corporations, made shareholders directly answerable to the corporation's creditors fourteen days after the corporation's assets were determined insufficient to pay its debts.[398] In 1822 this statute was amended to create unlimited liability for those who had been shareholders when the debt was incurred but who later got out.[399] However, in areas where this statute did not apply, such as corporations for turnpikes[400] and banks,[401] courts continued to apply the common law rule of limited liability. In his 1879 treatise on shareholder liability, Seymour Thompson noted that the Massachusetts courts strictly construed statutes that expanded shareholder liability in derrogation of the

393. T. COOPER, *supra* note 278, at 247.

394. *Id.* at 250.

395. *See generally* 1 J. DAVIS, *supra* note 388, at 17-18 (shareholders of aquaduct corporations in Massachusetts liable in case of dissolution); E. DODD, *supra* note 392; O. HANDLIN & M. HANDLIN, COMMONWEALTH: A STUDY OF THE ROLE OF GOVERNMENT IN THE AMERICAN ECONOMY: MASSACHUSETTS, 1774-1861, at 144-150 (1969).

396. Angell & Ames concluded in 1832 that broad shareholder liability was "peculiar to Massachusetts." J. ANGELL & S. AMES, *supra* note 5, at 361. The anonymous author of *Manufacturing Corporations*, 2 AM. JURIST 92, 101 (1829), came to the same conclusion.

397. E. DODD, *supra* note 392, at 374.

398. Act of March 3, 1809, 1809 Mass. Laws 464.

399. Act of Jan. 28, 1822, 1818-32 Mass. Laws 619.

400. *See* Commonwealth v. Blue-Hill Turnpike Corp., 5 Mass. 420, 422 (1809) (holding turnpike corporation, but not its incorporators, liable).

401. *See* Spear v. Grant, 16 Mass. 9, 15 (1819) (holding bank corporation, but not its corporators, liable). In Vose v. Grant, 15 Mass. 476 (1819), stockholders declared a large dividend after the expiration of their bank charter. *Id.* at 478-79. The dividend was nonfraudulent when declared since there appeared to be remaining assets sufficient to satisfy the company's debts. However, after the dividends were paid, two of the corporation's largest debtors, who were also officers, became insolvent and were unable to repay the corporation, which then failed to pay its creditors. Judge Jackson denied the creditors recovery against the stockholders, but suggested that equity might give the creditors a judgment against the stockholders for an amount not exceeding the dividend that had been recently declared. *Id.* at 479.

common law.[402]

During the 1820s, a public debate ensued in Massachusetts over shareholder liability, with liberals arguing that the state's policy of unlimited liability was driving capital to Maine and New Hampshire, states where limited liability prevailed.[403] An anonymous commentator in the 1829 *American Jurist* concluded that this peculiar feature of the Massachusetts debtor-creditor law had "driven thousands of her sons to other quarters of the country."[404] Furthermore, the author continued, Massachusetts' unlimited liability gave corporations with wealthy shareholders an "extensive credit," while those with less wealthy shareholders had to search for financing.[405] Relatively impecunious entrepreneurs who paid their entire fortunes into incorporated enterprise were at a disadvantage to rich investors who had much left over. That argument reveals its author as a Jacksonian. The author recognized that creditors had a right to security, but they would not be injured if they were entitled to "know the fund to which they trust" at the time when they make the loan.[406] Just as a potential creditor checks the assets of a natural person before making a loan, so too should the creditor inquire into the corporation's assets. The real problem for creditors was not limited liability but misstated capitalization. In many cases, the author noted, "but a small part of [the corporation's stated capital] is paid in." Clearly, "institutions carried on in this manner must be much more liable to failure than if the whole capital was paid in, as a much smaller loss would overwhelm them."[407] He then proposed a statute "requiring a certain part of the capital to be paid before the corporation commences operation, and the whole to be paid in before a certain date, and leaving corporators liable as partners, in case of a neglect to comply."[408]

In 1830, Massachusetts responded with a statute providing limited liability once all stated capital had been paid in.[409] Massachusetts' first general incorporation statute, passed in 1851, contained a similar provision.[410] Limited liability was well-established, even in conservative Massachusetts, by the end

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402. S. THOMPSON, A TREATISE ON THE LIABILITY OF STOCKHOLDERS IN CORPORATIONS § 50 (1879).

403. *See* J. ANGELL & S. AMES, *supra* note 5, at 362 (describing action taken to prevent capital flight).

404. *See Manufacturing Corporations*, *supra* note 396 at 93. Another commentator, writing a year later, also concluded that unlimited liability drove "millions of capital into the neighboring states for investment. And there it will remain." *Corporations*, 4 AM. JURIST 298, 307 (1830).

405. *Manufacturing Corporations*, *supra* note 396, at 105.

406. *Id.* at 116.

407. *Id.* at 116-17.

408. *Id.* at 117.

409. Act of Feb. 23, 1830, 1828-1830 MASS. LAWS ch. 53, § 6 325, 328.

410. Act approved May 15, 1851, 1851 MASS. ACTS ch. 133; *see* E. DODD, *supra* note 392, at 385 (discussing provisions of the 1851 Act).

of the Jackson era.[411]

New York, probably the state with the greatest influence on antebellum American corporate law, accepted limited liability less reluctantly. Like Massachusetts, New York went through a period in which it narrowly applied the common law rule of limited liability and a subsequent Jacksonian period in which the rule was substantially restored with a distinctively classical architecture.

An 1826 New York court decision[412] that a statute authorizing manufacturing corporations required "double libility" of shareholders set off a Jacksonian revolt. The result was a general statute in 1828 providing limited liability to all shareholders whose shares were fully paid in.[413] Likewise, New York's general incorporation acts of the 1840s and 1850s provided for limited liability with respect to fully paid shares, but double liability before shares were fully paid in.[414] The 1848 general incorporation statute for manufacturers[415] influenced and provided a model for general incorporation acts in other states; it also has been described as imposing a general requirement of "double liability" on shareholders.[416]

In fact, the statute rested on a distinctly classical view of the capital market and the role of the corporation in facilitating the flow of capital toward economic development. Section 6 of the act authorized the corporation's trustees to "call in and demand" the stockholders' subscriptions—the money that they had promised to pay in, and upon which the announced capitalization of the company was based—if not fully paid.[417] If a shareholder did not pay on demand, he forfeited all shares, both paid-in and subscribed, and they could be resold.

Section 10 of the statute, which contained the "double liability" clause, provided:

> All the stockholders of every company incorporated under this act, shall be severally individually liable to the creditors of the company in which they are stockholders, to an amount equal to the amount of stock held by them respectively for all debts and contracts made by such company, *until the whole amount of capital stock fixed and limited by such company shall have been paid in* . . . .[418]

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411. *See* O. HANDLIN & M. HANDLIN, *supra* note 395, at 144-50 (limited liability in Massachusetts firmly established by 1820s).

412. Briggs v. Penniman, 8 Cow. 386, 392-95 (N.Y. Sup. Ct. 1826) (holding each stockholder liable for a sum equal to his stock subscription).

413. N.Y. REV. STAT. ch. 18, tit. 3, § 5 (1828-1835). The statute is described in Haar, *Legislative Regulation of New York Industrial Corporations, 1800-1850*, 22 N.Y. HIST. 191, 205-06 (1941).

414. R. SEAVOY, *supra* note 11, at 192.

415. 1848 N.Y. LAWS ch. 40.

416. Horwitz, *supra* note 329, at 208.

417. 1848 N.Y. LAWS ch. 40, § 6.

418. *Id.* at § 10 (emphasis added).

Section 12 required the trustees to make annual reports showing both the corporation's paid-in capital and existing debts.[419] If they failed to do this or misrepresented the numbers, they were jointly and severally liable for any corporate debts that exceeded paid-in capital. Section 18 of the statute made stockholders jointly and severally liable for employees' wages.[420] This clause, very common in nineteenth century general incorporation acts,[421] distinguished wages from other sorts of debts by providing for expanded shareholder liability.[422]

Finally, section 25 of the statute required trustees to keep an alphabetical list of stockholders, their addresses, their subscriptions, and the amount of money they had paid in.[423] This list had to be available to creditors during business hours. The book was "presumptive evidence of the facts stated therein, in favor of the plaintiff, in any suit or proceeding against such company, or against any one or more stockholders."[424] Officers or agents who failed to keep accurate records faced heavy fines. The statute did not provide for general shareholder liability after the shareholder's subscription was fully paid. Under the virtually unanimous rule, the absence of any provision meant limited liability.[425]

This New York statute and others modeled on it[426] rested on the premise that the paid-in capital of the corporation was a "fund" upon which creditors were entitled to rely. If the fund proved smaller than the par value of the stock multiplied by the number of outstanding shares, greater shareholder liability resulted. The rule, which came to be called the "trust-fund" doc-

419. *Id.* at § 12.

420. *Id.* at § 18.

421. 1 W. COOK, *supra* note 271, at § 215.

422. The New York courts construed this clause very narrowly. *See* Wakefield v. Fargo, 90 N.Y. 213, 217 (1882) (provision covered only "menial or manual services," not services of bookkeeper and general manager); Coffin v. Reynolds, 37 N.Y. 640, 646 (1868) (secretary not covered by provision); Aikin v. Wasson, 24 N.Y. 482, 484 (1862) (contractor not covered).

423. 1848 N.Y. LAWS ch. 40, § 25.

424. *Id.*

425. *See* Chase v. Lord, 77 N.Y. 1, 8-9 (1879) (applying limited liability under the statute); Matter of the Empire City Bank, 18 N.Y. 199, 218 (1858) (same); 1 W. COOK, *supra* note 271, at § 212.

426. *E.g.*, Act of Apr. 7, 1849, ch. 909, § 9, 1849 PA. LAWS 1173, 1176 (Dunlop 1849) ("All the stockholders . . . shall be . . . liable . . . for all debts . . . to the amount remaining unpaid on the shares of stock by them respectively held, until the whole amount of the capital stock as fixed . . . shall have been paid in . . . ."); Act of June 15, 1852, 1 IND. REV. STAT. ch. 24, § 7 at 240 ("If any part of the capital stock of such company shall be withdrawn and refunded to the stockholders, before the payment of all the debts of the company, all the stockholders of such company shall be jointly and severally liable for the payment of such debts"); *see also* Act approved May 18, 1846, ch. 15, no. 148, 1846 MICH. ACTS 265. At least one such statute preceded the New York statute. *See* Act approved Feb. 25, 1846, § 19, 1846 N.J. LAWS 64, 68 ("all the stockholders of every manufacturing company . . . shall be jointly and severally liable for all debts . . . until the amount of the capital stock . . . shall have been paid in").

trine, had sprung from Justice Story's opinion in *Wood v. Dummer*,[427] although some early corporate charters also expressly provided for it.[428] The Supreme Court adopted the doctrine in *Sawyer v. Hoag*.[429] The trust-fund doctrine held that if the stated value of the shares exceeded the amount of capital actually paid in—that is, if the stock was "watered"— then creditors could demand that the shareholders pay the corporation's debts. The doctrine applied only in limited liability jurisdictions, for example, New York and states that had copied its general incorporation statute.[430]

At first impression one would not consider limited shareholder liability to be a characteristic of the classical corporation, since it resembles a subsidy, that is, reduced legal liability for those who invest in corporations. Under classicism, each person usually must pay the full costs of economic decisions. Why was strengthened limited liability so important to the classical business corporation?

Principally, classical economic policy proved much more pragmatic than any existentialist notion that corporations should live up to the consequences of their acts. In this case, classical corporation theory perceived a "market failure" in the capital market. By their nature, new enterprises of the kind for which corporate charters were sought, carried the risk of uncertain future liability that could exceed paid-in capital. They trespassed on or flooded the lands of others. They injured people, particularly after the rise of the railroads. Or, most significantly, they failed, leaving behind lines of creditors. Limited liability greatly facilitated the flow of capital into new investments by allowing an entrepreneur with $50,000 in assets to invest $1,000 in a new incorporation without risking the other $49,000.

The classical, limited liability corporation was the preeminent nineteenth century risk-sharing device. It broadened the risk of failure to creditors as well as investors. In the process, limited liability encouraged further separation of ownership from control by attracting the "silent" investor, one with money to risk, but who did not wish to have to concern himself with the corporation's daily affairs. It also blurred the distinction between owners and creditors. Stockholders and bondholders became merely different classes

427. 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944); *see* Hume v. Winyaw & Wando Canal Co., 1 CAROLINA L.J. 217, 228-30 (S.C. 1826), (holding that when canal turnpike corporation had contracted debts, but possessed no paid-in capital, members of the corporation were liable up to amount of their subscriptions). *See* J. ANGELL & S. AMES, *supra* note 5, at 354-56; *On The Liability of Corporators*, 1 AM. L. MAG. 96, 99-100 (1843) (approving both the *Hume* decision and trust-fund doctrine).

428. See, for example, the 1789 charter of the Baltimore Manufacturing Co., described in J. DAVIS, *supra* note 242, at 267-68.

429. 84 U.S. (17 Wall.) 610, 622 (1873).

430. *See Manufacturing Corporations*, *supra* note 396, at 117-18, (defending limited liability and statutory enactment of trust-fund doctrine).

of "investors" in the same business. To be sure, different consequences attached to each instrument, but nothing like the traditional debtor-creditor relationship existed between shareholders and bondholders.

Creditors have always accepted part of the risk of failure of new enterprises. Even a middleman making a crop loan suffers if the farmer goes bankrupt.[431] Limited liability changed the stakes of the game by limiting creditors to going after the corporation's assets in the event of default. Creditors were forced to learn about the creditworthiness of the enterprise in which they were investing. The trustees also had to measure accurately the company's financial status, particularly the amount of paid-in capital, and make this information available to creditors and potential creditors on a daily basis. Creditors were entitled to rely on public information concerning the value of the corporation's assets against its debts. If the information proved accurate but the corporation failed, creditors were repaid only with corporate assets and stockholders had no further liability. Importantly, when creditors did not rely on such information, stockholders had no liability, regardless of whether their shares were fully paid in. For example, courts held that shareholders' statutory liability applied only to contract debts and not to tort judgments.[432]

Limited liability clearly encouraged the flow of capital into new enterprises. But it was not a "subsidy," because it did not transfer wealth from one class to another as, for example, cash subsidies transferred wealth from the taxpayers to recipient businesses. The wealth transfer certainly did not come from the corporation's consumers. Limited liability reduced the corporation's costs, and, therefore, probably its prices. The most obvious wealth transfer is from the corporation's creditors to its shareholders. But creditors knew about the limited liability and therefore built it into their calculations on whether to loan, how much, and on what terms. Furthermore, if limited liability was as effective as one might think in encouraging new investment—and there is every reason to think it was—then it greatly increased the demands for new loans. There is at least as much reason to believe that limited liability, on the whole, made corporate creditors better off rather than worse off.

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431. *See* A. CHANDLER, JR., THE VISIBLE HAND, 21-24 (1977) (middleman providing credit to farmers at risk in case of failure).

432. *See* Chase v. Curtis, 113 U.S. 452, 464 (1885) (tort judgment not a "debt" for which shareholders liable); Child v. Boston & Fairhaven Iron Works, 137 Mass. 516, 523 (1884) (patent infringement judgment and unsatisfied execution not a "debt" within meaning of provision holding shareholders responsible for debts); Cable v. McCune, 26 Mo. 371, 382-83 (1858) (judgment against corporation for negligent loss of steamboat did not create a "debt" within meaning of provision holding shareholders responsible for debts); Heacock & Lockwood v. Sherman, 14 Wend. 58, 60 (N.Y. Sup. Ct. 1835) (shareholders not responsible when horse fell from bridge even though charter appeared to provide for full shareholder liability; such liability for contract damages only).

Seen in this light, the limited liability corporation was not merely consistent with classicism, it was compelled by a classicism preoccupied with the efficient flow of capital. Inevitably, limited shareholder liability also encouraged limited shareholder involvement by encouraging them to be less concerned about the corporation's affairs. Limited liability was another of many doctrines, inherent in the classical theory of the corporation, that gradually gave responsibility for the corporation's affairs to management rather than to ownership.

The demise of the trust-fund doctrine late in the nineteenth century[433] was a natural consequence of the separation of ownership and control. By 1900 the corporation had grown large, and most of its governance had been given to professional management. Shareholders were little more than investors, and any real possibility of liability would have undermined the attractiveness of corporate stock as an investment. In the second edition of *Thompson on Corporations*,[434] Joseph Thompson indulged in a relentless attack on the trust-fund doctrine, finding it to be "at war with every principle of law and of sound reason."[435] If the doctrine had any proper meaning, Thompson concluded, it governed disposition of a corporation's assets upon dissolution. As long as a corporation is solvent, it is a distinct entity which "holds its property as any individual holds his."[436] On insolvency, however, its identity disappears and its property is "in the condition of trust, first for the creditors, and then for the stockholders."[437] This assertion was but a skeleton of the doctrine developed by Justice Story and early classicists.

VII. CORPORATE INDISCRETIONS: THE CHANGING NATURE OF QUO WARRANTO AND ULTRA VIRES

Inherent in the classical view of the corporation was a change in state attitudes toward corporate misbehavior. When the corporation was a special franchise from the state, authorized to do things that only the state itself could do, strict supervision of corporate activities was appropriate. But when it became just another form of private business organization, strict supervision was no longer in order. As part of the development of the classical corporation, responsibility for disciplining managers for legal but unauthorized or imprudent behavior moved from the state to the shareholders. Additionally, the standard of manager behavior slipped gradually until, by the end

433. *See* Horwitz, *supra* note 329, at 212-14 (explaining shift to public stock markets and the effect on the trust-fund doctrine).

434. S. THOMPSON & J. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS (2d ed. 1909).

435. 4 *id.* at 29.

436. *Id.* at 33.

437. *Id.* at 34.

of the century, it was legally answerable only for illegality, clearly ultra vires acts, and gross negligence.

A. CLASSICISM AND QUO WARRANTO FOR NONUSER

Within the mercantilist model, the corporation had a special contractual relationship with the incorporating state and received substantial protection of its "vested" rights. But a contract is a two-way arrangement and implies special obligations for the incorporators as well. Until the eighteenth century, business incorporation was the exception rather than the rule. Legislatures chartered corporations only when they wanted to obtain a particular public improvement. Many eighteenth century charters contained "self-destruction" clauses, which provided that the corporate charter would be forfeited if the planned project was not completed within a specified number of years.[438]

Regardless of whether the charter expressly contained such a clause, it was implied in every charter by the common law, as Justice Story noted in 1815:

> A *private* corporation created by the legislature may lose its franchises by a *misuser* or a *nonuser* of them; and they may be resumed by the government under a judicial judgment upon a quo warranto to ascertain and enforce the forfeiture. This is the common law of the land, and is a tacit condition annexed to the creation of every such corporation.[439]

Angell and Ames also argued in their 1832 treatise that incorporation created a two-fold obligation: first, by the incorporating state to guarantee the rights and privileges promised in the charter; second, by the incorporators to pay for and build the public improvement contemplated in the charter. "[I]t is now well settled, that it is a tacit condition of a grant of incorporation that the grantees shall act up to the end or design for which they were incorporated, and hence through neglect or abuse of its franchises a corporation may forfeit its charter, as for condition broken, or a breach of trust."[440]

This notion of corporate obligation rested on the premise that the proprietor of the corporation had been given a set of rights to something that was in the public interest but which one could not do without the state's permission. Performance was the incorporators' consideration for these rights. Without it, there was no contract. Some argued that consideration was so important that even a corporation in compliance with its charter was not entitled to collect tolls for activities that could have been undertaken without the corporation's involvement. For example, in 1804 the Richmond James River

438. *See* 2 J. DAVIS, *supra* note 242, at 227 (noting that canal, bridge, and turnpike charters commonly contained such provisions, but extensions were liberally given to those unable to complete projects on time).

439. Terrett v. Taylor, 13 U.S. (9 Cranch) 43, 51 (1815) (emphasis in original).

440. J. ANGELL & S. AMES, *supra* note 5, at 510.

Company was incorporated to widen and deepen a short section of the James River to facilitate navigation. The charter authorized it to collect tolls from all boats with a draft of five feet or more that passed through the improved section.[441] After the charter was issued, it was established that the river, unimproved, had been deep enough to accommodate boats with seven foot drafts. The legislature then concluded that it would be unfair to permit the corporation to charge tolls for boats with drafts betwen five and seven feet, since the corporation performed them no service and thus offered no "consideration." Over strenuous objections of the incorporators, the legislature amended the charter to exempt from toll any boat with a draft of less than seven feet.[442]

Quo warranto actions against corporations for nonuser— refusal to undertake the investment and business for which the corporation was designed— were common in the first half of the nineteenth century.[443] Only the government could bring such a proceeding, Angell and Ames noted, for only it was a party to the "compact" with the incorporators.[444]

But the classical corporation had a different kind of relationship with the state than did the mercantile corporation of Justice Story or Angell and Ames. Within classical theory, the general manufacturing corporation was an ordinary business firm and the state had no interest in whether the corporation undertook what its charter authorized. Angell and Ames noted that American courts had rejected the English rule that quo warranto would not lie "where the franchise no ways concerns the public."[445] Under the English rule, the information in quo warranto would be refused if the corporation had been created for purely private purposes. Gradually, however, American courts came to follow the English rule, holding that quo warranto for nonfeasance was an appropriate remedy for public utility corporations, in which the state had an interest in having a particular service delivered, but not for general manufacturing firms.

Even after the Civil War, American courts continued to adhere consistently to the rule that a turnpike company,[446] railroad company,[447] bank,[448]

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441. *See* An Act Improving the Navigation of the James River, 1803-1804 VA. ACTS ch. 103, § 9.

442. *See* B. Campbell, Law and Experience in the Early Republic: the Evolution of the Dartmouth College Doctrine, 1780-1819 at 252-253 (unpublished Ph.D. dissertation, Michigan State Univ., 1973).

443. *See, e.g.,* People v. Kingston & Middletown Turnpike Rd. Co., 23 Wend. 193 (N.Y. Sup. Ct. 1840) (turnpike company that failed to complete road as contemplated in charter; ouster); People v. Bristol & Rensselaerville Rd. Co., 23 Wend. 222 (N.Y. Sup. Ct. 1840) (same; no ouster); People v. Hillsdale & Chatham Rd. Co., 23 Wend. 253 (N.Y. Sup. Ct. 1840) (same; ouster and dissolution).

444. J. ANGELL & S. AMES, *supra* note 5, at 510.

445. *Id.* at 487.

446. *See, e.g.,* State *ex rel.* v. Nonconnah Turnpike Co., 17 S.W. 128, 131 (Tenn. 1875) (turnpike company forfeited charter for failure to construct road and bridges within specified time period);

water company,[449] or similar utility[450] that failed to build or operate the project contemplated in the charter, could be dissolved in a quo warranto proceeding. However, in the 1870s, some courts began to hold that a manufacturing corporation that did not operate the factories or manufacture the goods contemplated in the charter was not answerable in a quo warranto due to its failure to do business. "Purely business and manufacturing corporations formed under general statutes, and which are a species of business partnerships, are deemed dissolved when they cease to do business," conceded one Missouri court.[451] But this decision was "in reference to the rights of creditors,"[452] and not a breach of the corporation's charter. As a result, as long as the corporation had the requisite six members and no creditors' rights were disturbed, dissolution could not be compelled.[453]

Similarly, courts routinely began to hold that charter and statutory provisions demanding the forfeiture of corporations that did not go into business within the specified number of years were not self-executing, but required a quo warranto action by the state.[454] Since only the state conld bring a quo warranto action, the existence of such corporations could not be challenged

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Washington & Baltimore Turnpike Rd. v. State, 19 Md. 239, 292-93 (1862) (turnpike company lost charter for failure to maintain roads and bridges).

447. *See, e.g.*, People v. Broadway R.R., 126 N.Y. 29, 39, 26 N.E. 961, 963-64 (1891) (street railroad company forfeited franchise by failure to lay tracks on streets); State *ex rel.* Kansas City v. East Fifth St. Ry., 140 Mo. 539, 554, 41 S.W. 955, 958 (1897) (street railway company forfeited franchise by its failure to run cars for three years); *cf.* People v. Ulster & Del. R.R., 128 N.Y. 240, 250-51, 28 N.E. 635, 637 (1891) (state may prosecute or abandon, at its will, a corporation that has violated its franchise, so long as the public interest is at stake).

448. *See* People *ex rel.* Hunt v. National Sav. Bank, 129 Ill. 618, 624-25, 22 N.E. 288, 288 (1889) (failure to meet minimum specified capital subscription within specified time forfeited charter); People *ex rel.* Att'y Gen. v. City Bank, 7 Colo. 226, 227, 3 P. 214, 215 (1883) (same).

449. *See* City Water Co. v. State, 33 S.W. 259, 259 (Tex. 1895) (public corporation's failure to elect directors, hold meetings, or perform any corporate act was violation of corporate duty entitling state to forfeit charter).

450. *See* State v. Cannon River Mfrs. Assoc., 67 Minn. 14, 16-17, 69 N.W. 621, 622 (1896) (river improvement company misinvested funds, kept inadequate records, and ceased to have pecuniary interest in development of river; franchise forfeited).

451. State *ex rel.* Att'y Gen. v. Societe Republicaine, 9 Mo. App. 114, 120 (Mo. Ct. App. 1880).

452. *Id.* at 120.

453. *Id.* at 121; *see also* State v. Twin Village Water Co., 98 Me. 214, 213, 56 A. 763, 769 (1903) (state cannot require forfeiture of charter for nonfeasance when corporation showed willingness to deliver electricity as soon as individuals would pay reasonable price); State *ex rel.* Att'y Gen. v. Simonton, 78 N.C. 39, 41 (1878) (state cannot revoke charter of a private corporation for nonuser since no public interest had been affected).

454. *See, e.g.*, New York, Bridgeport & E. Ry. v. Motil, 81 Conn. 466 (1908); People *ex rel.* Hillel Lodge v. Rose, 207 Ill. 352, 69 N.E. 762 (1904); *In re* Brooklyn Elevated R.R., 125 N.Y. 434, 26 N.E. 474 (1891); Day v. Ogdensburg & Lake Champlain R.R., 107 N.Y. 129, 13 N.E. 765 (1887); Seaboard Airline Ry. v. Olive, 142 N.C. 257, 55 S.E. 263 (1906); Olyphant Sewage-Drainage Co. v. Borough of Olyphant, 196 Pa. St. 553, 46 A. 896 (1900); State *ex rel.* Preston Mill Co. v. Howell, 67 Wash. 377, 121 P. 861 (1912).

by private parties.[455] In the second edition of his extraordinary treatise on injuctions, originally published in 1893, Thomas Carl Spelling generalized that "a much stronger case" for quo warranto against a company for nonuser of its franchise "must be shown where the franchise is of a private nature than where the public are interested in having them kept in constant use."[456] Once again, this development widened the gap between general corporations and "franchises," or public utilities, where a much higher degree of state oversight was perceived as appropriate.

B. THE CLASSICAL CONCEPT OF ULTRA VIRES

Closely related to quo warranto was the substantive doctrine of ultra vires, which forbade the corporation and its officers from exceeding the corporation's authority. Violation of a general law was sufficient to justify either a quo warranto or an ultra vires action;[457] however, a corporation could also be dissolved or disciplined for acts legal under the general law, but contrary to the corporation's charter.[458] In short, actions could be brought to enforce legal obligations unique to a particular corporation or to corporations as a class distinct from unincorporated businesses. Although informations in the nature of a quo warranto could be brought only by the sovereign, ultra vires

455. *See Day,* 107 N.Y. at 139, 145, 13 N.E. at 767, 770 (non-compliance with requirement to construct railroad within 10 years did not alone dissolve company; simple creditors may only assert contract claim); *Seaboard,* 142 N.C. at 266, 55 S.E. at 266 (failure to organize railway within prescribed time period did not prevent later organization unless forfeiture was declared upon proceedings by state); *see also* Brown v. Wyandotte & S.E. Ry., 68 Ark. 134, 141, 56 S.W. 862, 863 (1900) (provision that charter is void unless railroad complies with certain conditions did not work automatic forfeiture, but merely establishes a ground upon which state could seek forfeiture); Utah, N. & C.R.R. v. Utah & C. Ry., 110 F. 879, 890 (C.C.D. Nev. 1901) (same).

456. 2 T. SPELLING, A TREATISE ON INJUNCTIONS AND OTHER EXTRAORDINARY REMEDIES 1562 (2d. ed. 1901).

457. *E.g.,* People v. North River Sugar Refining Co., 121 N.Y. 582, 623-24, 24 N.E. 834, 840 (1890) (refining company dissolved in quo warranto proceeding for entering partnership with other corporations thereby disregarding all salutory constraints involving consolidation of corporations); Manderson v. Commercial Bank, 28 Pa. 379, 382 (1857) (shareholder permitted to enjoin bank from conducting various illegal commercial activities).

458. *See* Eldred v. American Palace Car Co., 96 F. 59, 61 (C.C.D.N.J. 1899) (permitting stockholder suit challenging ultra vires sale of all company assets); Tillis v. Brown, 154 Ala. 403, 405, 45 So. 589, 589-90 (1908) (permitting minority stockholders to sue after directors sold all corporate assets at too low a price); Hinds v. Fishkill & Matteawan Gas Co., 96 A.D. 14, 16-17, 88 N.Y.S. 954, 955-56 (1904) (same); *Manderson,* 28 Pa. at 382 (permitting shareholder objection to bank's ultra vires discount of paper); Parsons v. Tacoma Smelting & Refining Co., 25 Wash. 492, 499, 65 P. 765, 768 (1901) (permitting nonassenting stockholder challenge to ultra vires lease); 2 W. COOK, *supra* note 271, at 968. Public challenges in quo warranto proceedings include State Bank v. State, 1 Blackf. 267, 281-82 (Ind. 1823) (bank franchise forfeited for contracting debt beyond charter limit); People *ex rel.* Platt v. Oakland County Bank, 1 Doug. 282, 288-91 (Mich. 1844) (bank fined in quo warranto proceeding for building unauthorized branch bank); State v. Madison Ry., 72 Wis. 612, 618, 40 N.W. 487, 489 (1888) (railway forfeited rights and privileges under charter for failure to maintain tracks as required in authorizing statute); State *ex rel.* Ellis v. Noncannah Turnpike Co., 17 S.W. 128, 131 (Tenn. 1875) (failure to construct road and erect bridges within time limit).

acts could be challenged by shareholders or others.[459]

The mercantile theory viewed the corporate charter as the Crown's permission to do something that, absent the charter, would be illegal. The other side of the coin was that the corporation, because of its privileged status, could engage only in authorized acts. When Angell and Ames wrote their treatise in 1832, they organized the powers of the corporation by reference to those things that a corporation could do without charter authorization: it could, for example, own real property,[460] make contracts[461] appoint agents and supervise their activities,[462] make its own by-laws,[463] and bring suits.[464] Everything else was illegal unless expressly authorized by the charter.[465] For a corporation "to assume a power which cannot be exercised, without a grant from the sovereign authority, or to intrude into the office of a private corporation contrary to the provisions of the statute which creates it, is, in a large sense, to invade the sovereign prerogative, to assume or violate a sovereign franchise."[466]

Classical corporate theory both narrowed and privatized ultra vires. When one thinks of the corporation as an entity composed of private persons but created by the state for a public purpose, strict scrutiny of corporate powers and activities seems appropriate. On the other hand, when the corporation is simply an alternative form of business organization, it should be able to do the same things as any other business firm. By the 1880s and 1890s courts had retreated from the view that a corporation's powers were defined by a strict construction of its charter. They became much more willing to imply authority from other explicit powers.[467] Even the Supreme Court, which usually construed corporate powers narrowly,[468] held in 1896 that the express power granted to a corporation to run a railroad implied the power to operate a hotel, at least if the hotel was for the convenience of railroad passengers and employees.[469] In 1894, William W. Cook, a promi-

459. *See generally* 2 W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK (7th Ed. 1913).

460. J. ANGELL & S. AMES, *supra* note 5, ch. 6.

461. *Id.* ch. 7.

462. *Id.* chs. 8 & 11.

463. *Id.* ch. 9.

464. *Id.* ch. 10.

465. *Id.* at 469-75.

466. *Id.* at 479.

467. L. FRIEDMAN, A HISTORY OF AMERICAN LAW 519-20 (2d ed. 1985).

468. *See, e.g.*, Thomas v. West Jersey R.R., 101 U.S. 71, 79 (1879) (railroad's lease of all its assets held ultra vires, even though railroad granted general authority to contract); Colson, *The Doctrine of Ultra Vires in United States Supreme Court Decisions* (pts. 1-2), 42 W. VA. L.Q. 179, 213, 297 (1936) (discussing *Thomas*).

469. Jacksonville, Mayport, Pablo Ry. & Navigation Co. v. Hooper, 160 U.S. 514, 526 (1896) (operation of seaside hotel at terminus of railroad was ancillary to railroad's business purpose and not ultra vires). *See* L. FRIEDMAN, *supra* note 467, at 519 (discussing *Hooper*).

nent corporations treatise writer, noted that the traditional ultra vires doctrine was disappearing rapidly.[470] By 1898, he proclaimed it dead, at least in state courts.[471] Fundamental to this development was the prevailing use of general incorporation acts rather than special charters. Some state courts held that the powers of a corporation formed under a general statute should be construed more broadly than those of a corporation created by special charter, because the former was more like an ordinary person engaged in business.[472]

However, once again a distinction had to be made between franchise or public service corporations and corporations engaged in general manufacturing. In the third edition of his treatise on corporations, published in 1894, Cook observed that the scope of permissible corporate activity had increased, and "many acts which fifty years ago would have been held to be *ultra vires* would now be held *intra vires.*" Likewise, "the courts have generally enlarged the implied powers of ordinary corporations . . . ."[473] But Cook noted that railroads bucked the trend; courts were "more strict" about finding railroad companies' acts ultra vires.[474] The new "regulated industries" treatises of the early twentieth century reflected the courts' continuing concern with ultra vires acts by public service or franchise corporations, particularly their vertical integration into unregulated markets.[475]

Even more significant was the change in the nature of challenges to ultra vires acts. State challenges gradually diminished as shareholders standing to challenge expanded. When Angell and Ames wrote their treatise, ultra vires acts were attacked principally in state-initiated quo warranto proceedings. Subject to a few exceptions, private parties could not bring their own actions.[476] Courts first began to approve shareholder challenges to ultra vires acts in the 1830s and 1840s, holding that the charter constituted a contract with the shareholder. The charter contained a promise by the corporation to engage only in activities allowed by the charter. The first such cases arose when the corporation tried to collect from a stockholder who refused to pay his subscription. The corporation could not compel payment if it had en-

470. 1 W. COOK (3d ed.), *supra* note 271, at 971-73.

471. 1 W. COOK (7th ed.), *supra* note 459, at vii-viii. The federal courts remained far more conservative, and kept the doctrine alive until the 1930s. Horwitz, *supra* note 329, at 187-88.

472. *See* Northside Ry. v. Worthington, 88 Tex. 562, 571-72, 30 S.W. 1055, 1058 (1895) (suggesting different standard for ultra vires in case of corporation chartered under general act).

473. 1 W. COOK, *supra* note 271, at 971-73.

474. *Id.*

475. *E.g.*, 1 B. WYMAN, *supra* note 272, at 572-79 (discussing restrictions on entry into related businesses); 2 W. COOK (7th ed.), *supra* note 459, at 895, 897, 908.

476. *See* J. ANGELL & S. AMES, *supra* note 5, at 475-80 (proceeding allowed by private party only when writ of quo warrants would not lie); Livingston v. Lynch, 4 Johns. Ch. 573, 595-96 (N.Y. 1820) (dicta) (suggesting actions against a corporation would be permissible only if all shareholders joined).

gaged in activity not authorized by the charter.[477] In most cases, the activity was not ultra vires, since the corporation had received a charter amendment authorizing the change. But these cases established that a charter in existence when the plaintiff subscribed was a contract governing both the plaintiff's liabilities and rights against the corporation.

In the 1850s, the emergence of stockholder derivative suits[478] had several implications for shareholder suits challenging activities as ultra vires. First, they justified shareholder challenges in principle. Second, the derivative suit created a judicial procedure that bound all shareholders and prevented multiple challenges with possibly inconsistent outcomes. Third, such suits required shareholders to establish that the directors had a legal duty to undertake or avoid a certain activity. If the activity was within the directors' discretion, the suit would not be sustained. From this emerged the "business judgment" rule which, by the turn of the century, gave directors broad protection from shareholder suits.[479]

By the 1880s, the stockholder suit had become widely accepted and had privatized the law of ultra vires. Meanwhile, states had virtually ceased being concerned about ultra vires acts unless they were independently illegal. Early in the nineteenth century, it was clear that a quo warranto would lie for corporations that engaged in activities not expressly authorized by the charter. But by 1900, the remedy, if any, was principally with the stockholders. In 1901 Thomas Spelling came to the following, rather startling, conclusion:

> There is a nice distinction necessary to be kept in view between corporate powers and corporate franchises. The occasional and temporary abuse of the former is a matter of complaint for the shareholders and creditors; but the state can object only when such abuse has been continued to the extent of involving and injuring public interests. The assumption of a mere power, such as any individual may assume, for instance the right to manufacture an article or to deal in evidences of indebtedness when not authorized by the charter, constitutes a ground of complaint by those privately

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477. *See, e.g.*, Middlesex Turnpike Corp. v. Locke, 8 Mass. 268, 271-72 (1811) (defendant who had subscribed to stock before legislature permitted charter amendment rerouting turnpike could not be required to pay for shares thereafter); Indiana & Ebensburgh Turnpike Road Co. v. Phillips, 2 Pen. & W. 184, 196 (Pa. 1830) (company cannot recover against original subscriber for subscription when subsequent legislation authorized company to be divided into two); Hartford & New Haven R.R. v. Croswell, 5 Hill 383, 385-86 (N.Y. 1843) (subscriber to shares cannot be forced to pay if charter was materially amended subsequent to subscription). *But cf.* Gray v. Monongahela Navigation Co., 2 Watts & Serg. 156, 160 (Pa. 1841) (grant of additional privileges to corporation does not relieve shareholder from obligation to pay for subscription, even though additional privileges might extend liabilities of company).

478. *See generally* L. FRIEDMAN, *supra* note 467, at 515 (discussing United States Supreme Court's approval of stockholder derivative suits).

479. *See infra* Part VII-C.

interested only, unless long continued, in which case the state may proceed by quo warranto.[480]

The cases Spelling relied on had held that quo warranto is not an appropriate remedy for resolving purely private disputes between corporations and others over property ownership;[481] a corporation's illegal efforts to dodge its creditors was not actionable by the state in quo warranto since the creditors and stockholders themselves had available legal remedies;[482] a corporation's wrongful entry onto private lands did not justify a quo warranto since the injured property owners could privately redress their grievances;[483] and, a bank that withdrew capital stock in the form of loans upon private security and allegedly loaned out more money than its charter authorized was not answerable in quo warranto since the bank was skillfully managed and no danger to the community could be shown.[484] The remedy in such cases must lie with either the stockholders or the injured creditors.

Increasingly the rule became that corporate activities outside the charter were a matter of internal firm management and not of state concern unless the corporation were a "franchise" or public utility, or unless the abuse could be shown to injure the public interest.[485] This privatization of ultra vires law effectively put the general manufacturing corporation on the same footing as an unincorporated firm: internal mismanagement or bad decisions in marketing or production were the owners' problems, not the state's, unless laws were broken. As Spelling noted, "It is not sufficient then for [the state] to show that wrong has been done to someone; the wrong must appear to be done to the public in order to support an action by the people for redress."[486] Later cases held that even illegal acts did not justify quo warranto if they resulted in purely private wrongs— that is, wrongs that the victims could redress in a civil suit.[487] There was one very important qualification to this

480. 2 T. SPELLING, *supra* note 456, at 1566.

481. State *ex rel.* Waddell v. Pittsburgh, Y. & A. R.R., 50 Ohio St. 239, 250-51, 33 N.E. 1051, 1053 (1893).

482. State *ex rel.* Clapp v. Minn. Thresher Mfg. Co., 40 Minn. 213, 216, 41 N.W. 1020, 1025 (1889).

483. State v. Kill Buck Turnpike Co., 38 Ind. 71, 72 (1871).

484. State v. Essex Bank, 8 Vt. 489, 490-91 (1836).

485. *See* People *ex rel.* Koerner v. Ridgley, 21 Ill. 64, 66 (1859) (holding that since public interest was not implicated, quo warranto challenge to trustee's operation of bank was inappropriate as long as outsiders not defrauded).

486. 2 T. SPELLING, *supra* note 456, at 1576.

487. *See* State v. Minn. Thresher Mfg. Co., 40 Minn. 213, 226-27, 41 N.W. 1020, 1025 (1889) (although issuance of corporation's stock for stock and indebtedness of predecessor company is ultra vires if fraudulent, state quo warranto proceeding unnecessary because stockholders and creditors possessed adequate remedy); State *ex rel.* O'Brien v. Kill Buck Turnpike Co., 38 Ind. 71, 72 (1871) (quo warranto inappropriate where turnpike company committed trespass during construction of roadway since landowners have ample legal remedies to redress private damages).

rule: if the ultra vires act created an illegal monoploy, courts found an injury to the public interest sufficient to justify quo warranto.

C. THE BUSINESS JUDGMENT RULE

The business judgment rule establishes the liability standard of corporate directors to stockholders for mismanagement. In 1853 the Rhode Island Supreme Court stated the rule this way: "a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fell into a mistake, either as to law or fact, are not liable for the consequences of such mistake."[488] During the second half of the nineteenth century, state courts divided sharply over the appropriate standard for business judgment. In his influential treatise on private corporations, Wall Street lawyer Victor Morawetz suggested that directors should not be liable if they "act honestly within the powers conferred upon them by the charter," indicating that the rule protected everything but subjective bad faith.[489] Many courts took that position. For example, in *Spering's Appeal*[490] the Pennsylvania Supreme Court held that "while directors are personally responsible to the stockholders for any losses resulting from fraud, embezzlement or wilful misconduct or breach of trust for their own benefit," they were not liable for "mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and . . . within the scope of the powers and discretion confided to the managing body."[491] But the New York Court of Appeals squarely disagreed, concluding that the correct standard was "ordinary skill and judgment of a reasonable person."[492] In other words, directors were liable for ordinary negligence.

But the Pennsylvania Supreme Court's approach clearly dominated[493] and

488. Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853). *See* Godbold v. Branch Bank, 11 Ala. 191, 199 (1847) (directors not held to standard of "perfect knowledge" and therefore not held liable for innocent mistakes).

489. 1 V. MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 237 (2d ed. 1886).

490. 71 Pa. 11 (1872).

491. *Id.* at 24.

492. Hun v. Cary, 82 N.Y. 65, 71 (1880) (applied standard of "ordinary care and prudence" of same degree that people "generally exercise in their own affairs").

493. *See* Jessup v. Illinois Cent. R.R., 43 F. 483, 496-97 (C.C.N.D. Ill. 1890) (directors acting in good faith not liable for failure to include unforeseen contingencies in lease contract); Witters v. Sowles, 31 F. 1, 2 (C.C.D. Vt. 1887) (directors not liable for imprudent and risky loan, provided they acted in good faith); Smith v. Prattville Mfg. Co., 29 Ala. 503, 508-09 (1857) (mere errors of judgment by managers do not entitle stockholder to relief; a willful abuse of directors' discretion, bad faith, or willful neglect or breach of a known duty required for liability); Neall v. Hill, 16 Cal. 145, 150-51 (1860) (liability for diminution in value of stock resulting from mismanagement should be found only in clear case of gross negligence or willful misconduct); Dunn's Adm'r v. Kyle's Ex'r, 77 Ky. (14 Bush) 134, 140-41 (1878) (gross negligence or bad faith required to hold directors liable for alleged mismanagement); Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853) (directors

was adopted by the Supreme Court in *Briggs v. Spaulding*.[494] As a result, William Cook concluded in the 1894 edition of his treatise, the federal business judgment rule "largely exempt[s] directors in national banks from any liability whatsoever."[495] In his treatise on corporations published in 1895, Seymour Thompson concluded that for "mere errors of judgment by the officers of a private corporation, by which damage has been done to a member of a corporation, an action at law does not lie."[496] To recognize an action would "destroy the discretion vested" in the directors by making it constantly subject to court review. Rather, "it must appear that the act complained of was willful and malicious, and done for the purpose of injuring the plaintiff."[497] Thompson finally concluded that a distinction must be drawn between the directors' discretionary and ministerial acts. However, in neither case was the standard particularly high:

> 1. Where directors are clothed with a *discretion*, they are not responsible to the corporation for damages flowing from an exercise of this discretion, however erroneous their exercise of it may have been. 2. In respect of their *ministerial* duties, they are not responsible to the corporation for anything short of gross negligence, non-attendance, and fraud, whereby frauds have been perpetrated, or the property of the corporation embezzled or wasted.[498]

The liberalization of the business judgment rule gave corporate managers more discretion and shareholders less control. The irony of directors' decreased liability, C. Brewster Rhoads lamented in 1916, was that those states that had required a showing of willful dishonesty or gross negligence had begun with a premise perhaps valid in the early part of the century that directors are "'gratuitous mandatories,' serving without compensation."[499] However, the latter part of the nineteenth century witnessed a change in the status of directors. They now held coveted professional positions, often offering high monetary rewards. The director, rather than the owner, had the real power and was in a position to control the corporation to his

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acting in good faith and with due diligence not liable for mistake of fact or law); Henry v. Jackson, 37 Vt. 431, 432 (1865) (directors' duty to obey bylaws governed by negligence, rather than strict liability standard). Other cases are cited in 2 W. COOK, *supra* note 271, at 1031 n.1.

494. 141 U.S. 132, 163-66 (1891) (bank directors not liable for failing to discover losses; directors have duty of reasonable supervision and may be liable only if grossly inattentive).

495. 2 W. COOK, *supra* note 271, at 1031 n.1.

496. 3 S. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 4101 (1st ed. 1895).

497. *Id.* Thompson stated the rule even more strongly in his second edition, published in 1908-1910. 2 S. THOMPSON, § 1270.

498. 3 S. THOMPSON, *supra* note 496, § 4105 at 2996-97 (emphasis in original).

499. Rhoads, *Personal Liability of Directors for Corporate Mismanagement*, 65 U. PA. L. REV. 128, 132 (1917).

advantage.[500]

D. THE MONOPOLY PROBLEM AND THE CHANGING NATURE OF QUO WARRANTO AND ULTRA VIRES

Both quo warranto and the doctrine of ultra vires remained alive throughout the nineteenth century. However, the underlying rationales for the actions underwent an important change. In the first half of the century, the principal concern about corporate expansion was that the corporation would claim unauthorized privileges[501] or would fail to perform activities for which it was contractually obligated.

But after the Civil War, informations in the nature of quo warranto were brought frequently to challenge perceived anticompetitive activities of corporations, first vertical integration and later horizontal combinations of various kinds. Quo warranto and the doctrine of ultra vires became the legal tools for dealing with monopoly, a problem not identified by the presence of a corporate charter, although it was unquestionably facilitated by the rise of the business corporation.

Corporate charters initially appeared to contain powerful weapons for state trustbusters. The weapons were the remaining vestiges of the pre-classical theory of the corporation: statutes and charter provisions prohibiting the corporation from doing business outside the incorporating state, and prohibiting one corporation from owning the shares of another.[502] Supporting these provisions was the doctrine that a state could exclude corporations chartered in other states from doing business within its borders.[503]

For the giant business firms beginning to organize in the 1870s and 1880s, these restrictions were an albatross, and corporations sought every means to avoid them. In fact, the words "trust" and "antitrust" derive from the fact that late nineteenth century monopolists used the common law trust arrangement to evade charter-imposed limitations. Eventually, however, even the common law trust proved inadequate. The great combinations then petitioned and obtained from states such as New Jersey, new incorporation acts that permitted incorporation for any lawful purpose and also allowed ownership by a corporation of another corporation's shares.[504] These statutes eradicated most remaining vestiges of the pre-classical corporation. Under them,

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500. *Id.*

501. *See* People v. Utica Insurance Co., 15 Johns 357, 386 (N.Y. 1818) (quo warranto condemning insurance company's move into banking).

502. *See* L. FRIEDMAN, *supra* note 467, at 515-20.

503. *See* McCurdy, *The Knight Sugar Decision of 1895 and the Modernization of American Corporation Law, 1869-1903*, 53 BUS. HIST. REV. 304 (1979).

504. *See* N.J. LAWS ch. 185, at 279; *see also* L. FRIEDMAN, *supra* note 467, at 520.

a business corporation could do almost everything that any unincorporated firm could do.

By the late nineteenth century, courts generally held that states could not use quo warranto merely to challenge a business corporation's violation of the terms of its charter. To succeed, they had to show injury to the public interest. But when unauthorized activities created a monopoly the rule changed. As Thomas Spelling summarized: "[I]n a proceeding against a corporation by quo warranto for having formed with others a monopoly in the shape of a 'trust,' no actual public injury need be proved, but it will be presumed when an agreement is shown which, if carried out, will obviously result to the public detriment."[505] That is, the state's concern with ultra vires activities reappeared when the activities undermined the competitive market system.

The courts did not have unlimited power to condemn monopoly. Even if injury to the public was presumed, a corporation was not answerable in quo warranto unless it violated either the terms of its charter or some independent law. The challenge for the monopolists was to devise trust arrangements that did neither. Sometimes they succeeded. For example, the implied right of every corporation to enter into sales contracts gave the directors authority to determine those contracts' terms. A New Jersey chancery court found no problem with American Tobacco's policy of refusing to sell cigarettes to buyers who also purchased cigarettes from a competitor, and of maintaining the resale price of its products.[506] Neither practice violated common law, the court concluded, and the right to contract must be respected.

Similarly, although most corporations chartered during the nineteenth century were forbidden from owning shares in other corporations or from forming partnerships or trusts with other corporations,[507] they could acquire property. As a result, many courts did not find mergers by asset acquisition to be ultra vires. The New York Court of Appeals refused to condemn an apparent monopoly that occurred when one match producer acquired all the assets, including the goodwill, of another match producer.[508] The court found that the corporation had the power under its charter to acquire property, the merger was apparently legal under common law, and no statutes

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505. 2 T. SPELLING, *supra* note 456, at 1567. Among other cases, Spelling cited Chicago Life Ins. Co. v. Needles, 113 U.S. 574 (1884) and Ward v. Farwell, 97 Ill. 593 (1881).

506. Stockton v. Am. Tobacco Co., 36 A. 971, 55 N.J. Eq. 352 (N.J. Ch. 1897), *aff'd sub nom* Miller v. Am. Tobacco Co. 42 A. 1117 (N.J. 1898) (per curiam).

507. *See* V. MORAWETZ, *supra* note 489, at 431-32; Thompson, *The Consolidation of Competing Corporations*, 27 AM. L. REV. 330, 341 (1893) (absent express authorization in corporate charter, corporation cannot acquire stock in another corporation; even when such authorization exists, courts have declared stock purchase for purpose of controlling rival to be against public policy).

508. Diamond Match Co. v. Roeber, 106 N.Y. 473, 486 (1887).

were violated.[509] In approving of the decision, Thomas Spelling concluded that "[t]he most important factor of commercial life is the liberty of contracting, and it should not be abridged except where it is made clear that the public will be injuriously affected by its unrestrained exercise in a particular case."[510]

However, a corporation did not have authority to transfer its "franchises and other delegated powers" to another corporation.[511] Such an act automatically justified quo warranto. For example, the sugar trust was formed when the shareholders in several sugar manufacturing corporations transferred their shares to a board of trustees under a common law trust arrangement. The board then issued trust certificates to the shareholders representing their interest in the entire enterprise. Each corporation in turn delegated its power to make operational decisions to the board of trustees. The result was an effective merger to monopoly. But the New York Court of Appeals condemned it because the charters of the individual New York corporations did not give them authority to enter into partnership agreements with others.[512] The Standard Oil trust met the same fate in the Ohio courts, which found that Standard's charter gave it no authority to enter into partnerships.[513] Further, the charter implicitly required Standard's directors to control the corporation for the benefits of its shareholders. The trust agreement effectively ceded the directors' authority to the trustees.[514]

The revitalization of quo warranto in the state trust cases was the first great crisis faced by the classical theory of the business corporation in the age of giant enterprise, and the theory did not fare well. The corporation had escaped state control. For example, Standard Oil Company of Ohio complied with the Ohio Supreme Court's divestiture decree by setting up a new corporation under the liberalized corporations laws of New Jersey. Then, the corporate members of the trust made perfectly legal transfers of their assets to the newly formed Standard of New Jersey.[515]

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509. *Id.*

510. 2 T. SPELLING, *supra* note 456, at 1568.

511. *Id.* at 1570.

512. People v. North River Sugar Refining Co., 121 N.Y. 583, 622-26 (1890). For other attempted monopolies struck down for similar reasons, see People v. Chicago Gas Trust Co., 130 Ill. 268, 302-03, 22 N.E. 798, 806 (1889) (stock acquisition of four gas companies giving effective control to the Chicago Gas Trust Co. held impermissible as beyond the objects of their incorporation and against public policy); State v. Nebraska Distilling Co., 29 Neb. 700, 719-20, 46 N.W. 155, 160-61 (1890) (distilling company's attempt to form monopolistic combination held unlawful as beyond the terms of its charter and against public policy).

513. State v. Standard Oil Co., 30 N.E. 279, 290 (Ohio 1892).

514. *Id.*

515. *See* 2 A. NEVINS, STUDY IN POWER: JOHN D. ROCKEFELLER, INDUSTRIALIST AND PHILANTHROPIST 230-44 (1953) (small investors refused to dissolve their trust certificates, and the interlocking directorates of the newly formed corporations left the trust agreement effectively intact

The classical corporation became a victim of its own success. Its problem was not that it was bad at doing the job for it which was conceived, that is, efficiently assembling and directing business capital. On the contrary, it did the job so well that by the end of the century it threatened the competitive market structures for which it had been created.

VIII. THE DECLINE OF CLASSICAL CORPORATE THEORY

A. CLASSICISM AND COMPETITION

Neoclassical political economy and the classical business corporation collapsed together. The great events signalling the fall of neoclassical political economy were the publication of Joan Robinson's *Economics of Imperfect Competition*[516] and Edward Chamberlin's *Theory of Monopolistic Competition*[517] in 1933. The event signaling the fall of the classical business corporation was Adolph Berle's and Gardiner Means' book, *The Modern Corporation and Private Property*,[518] published in 1933. Each in its own way, these books presented theories of market and business firm behavior that were inconsistent with the classical models that preceded them. The economics of Robinson and Chamberlin operated within a classical model in which "markets" were the fundamental unit of business analysis, but their own works contributed greatly to the breakdown of that model. Berle's and Means' work came out of an institutionalist economic tradition that became important in America during the Progressive era and which placed much more emphasis on the behavior of the individual firm. Although the approaches taken by these books differed dramatically, they responded to the same phenomenon: the awesome growth of the business corporation and the apparent failure of the classical model of competition.

Classical political economy had developed a model of "perfect competition" that it had used to analyze most economic concepts. The perfect competition model, which was not perfected until the twentieth century,[519] was built on three important assumptions: 1) all firms making a particular product make exactly the "same" product, subject only to such size or quality

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though technically dead); P. COLLIER & D. HOROWITZ, THE ROCKEFELLERS: AN AMERICAN DYNASTY 29-36 (1976) (discussing how Rockefeller set up the Standard trust).

516. J. ROBINSON, THE ECONOMICS OF IMPERFECT COMPETITION (1933).

517. E. CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (1933).

518. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

519. *See* Stigler, *Perfect Competition, Historically Contemplated*, 65 J. POL. ECON. 1, 10-11 (1957) (attributing formulation of the model to John Bates Clark and Frank Knight in the 1920s); J.B. CLARK, THE DISTRIBUTION OF WEALTH, 56-81 (1899) (adding mobility of resources and model of stationary economy to existing theories of conditions for competition, thus producing the modern concept of perfect competition); F. Knight, RISK, UNCERTAINTY AND PROFIT 51-196 (1921) (describing theory of choice and exchange under perfect competition and positing minor prerequisites for its existence).

variations as individual purchasers might wish in a particular transaction; 2) individual firms have unrestricted, easy entry and exit from markets; and 3) "constant returns to scale," that is, all firms have the same cost per unit of output regardless of their size. Although a working model of perfect competition had not yet been developed, most of the great works in the classical tradition assumed these market characteristics, even as late as Alfred Marshall's great synthesis in 1890.[520] In fact, the explicit articulation of the perfect competition model in the 1920s invited the attack on the model in the 1930s and 1940s.[521] Just as the perfect compretititon model matured in the economics literature, the structure of the business firm evolved in ways that called into question the three fundamental assumptions of perfect competition. The result was an economic theory that appeard unable to explain basic price and output phenomena.

Classicism's theory of competition looked a good deal like the model of evolution by natural selection developed in 1859 by Charles Darwin.[522] The popularizers of competition theory used Darwinian analogies liberally. For example, Professor Jeremiah W. Jenks, who taught industrial economics at Cornell, wrote a popular book glorifying monopolies and trusts because of their efficiencies: "the one who shows on the whole the greatest power of self-reliance, self-direction, and skill—the fittest—is the one who, in the competitive struggle, survives."[523] In his famous article on "Wealth," Andrew Carnegie explicitly compared the process of economic competition to the struggle of the species for survival.[524] People such as Jenks and Carnegie were confident that competition would force each firm to produce the best product at the lowest cost or decline and close. If an innovation made products better or cheaper, it would have to be copied by every firm in the market. Those that did not do so would suffer the consequences. In this way, the invisbile hand—market competition—would guarantee consumers the best combinations of price and quality.

But this model of competition failed to account for the possibility that one

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520. A. MARSHALL, PRINCIPLES OF ECONOMICS (1st ed. 1890).

521. *See* Stigler, *supra* note 519, at 11 (asserting that Knight's "meticulous discussion" of perfect competition in RISK, UNCERTAINTY, AND PROFIT drove home the theory's austere nature and paved the way for widespread criticism in the 1930s).

522. C. DARWIN, ON THE ORIGIN OF SPECIES BY NATURAL SELECTION (1859).

523. J.W. JENKS, THE TRUST PROBLEM 195 (1900).

524. Carnegie, *Wealth*, 148 N. AM. REV. 653, 655-56 (1889). *But cf.* C. RUSSETT, DARWIN IN AMERICA 92-96 (1976) (few American entrepreneurs could be Social Darwinists because nearly all lacked the formal education necessary to have been exposed to it). Indeed, rather than applying biology to economics—as Social Darwinists did to justify continuation of the laissez-faire policies of classical economic theory—the ORIGIN OF SPECIES more nearly applied classical economics to biology. *Id.* at 93. *See* Hovenkamp, *supra* note 1, at 417-20 (characterizing Social Darwinism as "the most overrated of Gilded Age ideologies" and describing the much older moral and religious roots of laissez-faire economics).

or a small group of firms might become so "fit" that they would drive everyone else from their market. At that point, the theory fell apart. Once competition disappeared, the invisible hand no longer guaranteed that the market alone would produce the best combination of quality and price. Ironically, the very success of the business corporation appeared to produce just this situation.

The federal antitrust laws were the first broadly-supported attempt to solve the monopoly problem, in this case, by shoring up the classical competition model so that the invisible hand could be made to work again. But by the second and third decades of the twentieth century, economists saw that antitrust laws had failed to do the job. The far-from-perfect market needed more radical, more regulatory, approaches.

B. THE REVOLUTION IN THE THEORY OF COMPETITION

The competition model of classical and much of neoclassical political economy assumed fungible products, small firms, easy entry and exit from business, and constant returns to scale. In such a market, every firm charged the competitive price and the first firm that attempted to raise prices would instantly lose all sales.

But the classical model of competition contained a fundamental contradiction: the very nature of political economy was to suggest ways in which firms could "economize," and fundamental to the notion of economizing was the principle that specialization and volume could reduce costs. Adam Smith recognized this when he suggested that the "extent of the market" explains the "division of labor," or specialization.[525] As firms specialize, they can do things more cheaply, but the number of units of output of a single firm increases. For example, a craftsman who produced an entire carriage might complete only four or five per year. But if he produced only wheels, he might make enough per year to equip one hundred carriages. He also might make the wheels at a lower cost. All this assumes that the market could absorb one hundred carriages. As population density grew and improved transportation made markets larger, one manufacturer could supply many more people, making further specialization feasible.

Inherent in the classical competitive process was each firm's urge to increase the "extent" of its market, thereby reducing production costs through economies of scale. Other early classicists, such as David Ricardo, recognized that the competitive model assumption of constant returns to scale did not accurately describe real-world behavior.[526] But Ricardo never revised

525. A. SMITH, *supra* note 93. *See* Stigler, *The Division of Labor is Limited by the Extent of the Market*, 59 J. POL. ECON. 185 (1951).

526. *See* Cordell, *The Preface to Robinson & Chamberlin*, 44 INDIAN J. ECON. 257, 259-61

the model to account for the problem of decreasing costs—the notion that firms become larger and more specialized as a result of competitive processes.

One important corollary to the notion of decreasing costs resulting from the division of labor was product differentiation, also inconsistent with the classical model. As a rule, one shop could make four hundred carriage wheels per year at less cost than two shops each making two hundred wheels. This suggested that eventually a market would contain only a single carriage wheel manufacturer, because larger firms with lower costs would drive smaller ones from the market. But two, five, or even more competing shops continued to exist in many markets, because each made a product distinguishable from that of its competitors. Some shops had a reputation for manufacturing high quality, high price wheels, others, poor quality, cheap wheels, and still others were known for a sturdy wheel lacking in elegance. Each shop filled a distinct niche in a single market.

Once again, classical political economy recognized this fact. In the 1840s John Stuart Mill acknowledged that not all firms in the same market sell at exactly the same price. A single town such as London had its "cheap shops" and "dear shops," to which different groups of customers went to satisfy their needs.[527] But once again, the notion of product differentiation did not lead to substantial revision of the perfect competition model, not even in the neoclassical period.[528] The great neoclassicist Alfred Marshall suggested the phenomenon of product differentiation in a footnote in the fourth edition of his *Principles of Economics* in 1898.[529] As a result of product differentiation, Marshall concluded, each firm in a market might face a slightly different demand for its product, rather than all the firms being in precisely the same position, as the classical theory assumed.[530] With that observation Marshall let the matter rest. He apparently failed to realize the implications of his observation: that firms in product differentiated markets do not "compete" as much as firms in markets where products are fungible. Firms in product-differentiated markets eventually begin to behave like monopolies.

Equally important, economies of scale made entry of new firms into business more difficult. The classical model assumed that monopoly profits in an unregulated industry were impossible since new competitors would enter the market if an industry earned higher profits than other industries. As late as the 1880s, this argument was applied even in industries where economies of scale were obvious, such as the railroads. For example, Gerritt Lansing ar-

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(1964) (describing transition from Smith to Ricardo to Mill regarding their theories on economies of scale and decreasing costs).

527. J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY, Book II, at 246 (1848; 1920 rep. ed.).

528. *See* Stigler, *supra* note 525, at 186.

529. A. MARSHALL, PRINCIPLES OF ECONOMICS 513 n.1 (4th ed. 1898).

530. *Id.*

gued that rate regulation of railroads was unnecessary because, as long as they were not protected by legal monopolies, new railroads would be built until the rate of return fell to the competitive level.[531]

But increasing returns gave large firms an advantage over new rivals and prospective entrants. Already in 1890, Alfred Marshall observed that smaller manufacturers in industries subject to such economies of scale did not have as much to devote to research or experimentation,[532] nor could they distribute or market as efficiently.[533] Marshall concluded that "the advantages which a single powerful firm has over its smaller rivals in those industries in which the Law of Increasing Return acts strongly," might be enough to give it "a practical monopoly of its own branch of production," provided it were well managed.[534]

As is often the case, the classical theory of competition did not change until an overwhelming array of unexplained facts made the existing model unacceptable. By the turn of the twentieth century it was clear that different prices in the same market, product differentiation, and economies of large size were not anomolies, but a large and apparently permanent part of the world economy.[535]

The development of the railroad, more than anything else, prompted the reformulation of the perfect competition doctrine. A specialized branch of political economy extensive enough to be called "railroad economics" began to develop in the United States in the 1860s and virtually exploded in the 1870s.[536] Initially, the writing on railroad economics was contextual, and

531. Lansing, *The Railway and the State*, 138 NO. AM. REV. 461, 462-63 (1884); *see* Hovenkamp, *Regulatory Conflict*, *supra* note 3, at 1031.

532. A. MARSHALL, *supra* note 520, Book IV, at 341.

533. *Id.* at 343.

534. *Id.* Book V, at 464 n.1.

535. *See* Chamberlin, *The Origin and Early Development of Monopolistic Competition Theory*, 75 Q. J. ECON. 515, 540-43 (1961) (explaining Marshall's understanding of monopolies). Chamberlin noted that the prevalence of tautological economic explanations was a stimulus for new theoretical approaches. *Id.* at 520-21. "The search for the 'reason why' was given added impetus by the discovery that with some writers no reason was given at all." *Id.*

536. The literature, which includes hundreds of articles and dozens of books, is analyzed in Hovenkamp, *Regulatory Conflict*, *supra* note 3. The most prominent works include, in chronological order: Potts, *The Science of Transportation*, 2 J. SOC. SCI. 115 (1870); C.F. Adams, Jr., *The Railroad System*, in C. ADAMS & H. ADAMS, CHAPTERS OF ERIE AND OTHER ESSAYS, 360-66 (1871); Adams, *The Government and the Railroad Corporations*, 112 N. AM. REV. 31 (1871); A.T. HADLEY, RAILROAD TRANSPORTATION: ITS HISTORY AND LAWS 63-74 (1885); Hadley, *Private Monopolies and Public Rights*, 1 Q.J. ECON. 28 (1886); Seligman, *Railway Tariffs and the Interstate Commerce Law. I.*, 2 POL. SCI. Q. 222, 222-27 (1887); Taussig, *A Contribution to the Theory of Railway Rates*, 5 Q.J. ECON. 438 (1891); H.T. NEWCOMB, RAILWAY ECONOMICS, chs. 10-16 (1898); W. RIPLEY, RAILROADS: RATES AND REGULATION (1912); Agger, *Monopoly and Competitive Prices*, 3 AM. ECON. REV. 589 (1913); Clark, *Some Neglected Phases of Rate Regulation*, 4 AM. ECON. REV. 565 (1914); and Lorenz, *Cost and Value of Service in Railroad Rate-Making*, 30 Q.J. ECON. 205 (1916).

emphasized the uniqueness of railroads, particularly their high fixed costs, extensive economies of scale, and extreme price discrimination. For example, in his 1885 study of railroads, Yale political economist Arthur Twining Hadley noted an important phenomenon caused by their high fixed, or "overhead," costs: prices under competition would be driven to variable costs without enough to cover the fixed costs.[537] As a result, price discrimination seemed essential to the industry's survival; railroads needed to recover overhead or capital costs from customers who could be made to pay them and along routes that were least competitive. Too much competition would be ruinous.

As the literature on railroad economics developed in the 1880s and 1890s, it grew increasingly theoretical and conceptual, and began to view railroads as only an extreme example of characteristics widespread in modern industry: high capital costs; substantial economies of scale; price discrimination; and, the likelihood of "ruinous" competition if too many firms operated in the same market niche.

The article that planted the destructive seed was Taussig's 1891 *A Contribution to the Theory of Railway Rates*.[538] Taussig argued that industries subject to very high fixed costs and which produced differentiated products in the same plant could not economically allocate fixed costs to each product separately.[539] In the case of railroads, the different products were the various classes of goods shipped. For example, the railroads incurred different operating costs in shipping valuable furniture, which needed careful handling than coal, which did not. But it was impossible to assign differential amounts of the amortization of the fixed costs, such as the investment in terminals and track, to shipments of these different products. As a result, Taussig concluded, the value of the service to the consumer was a better basis for railroad rate-making than the cost of service to the railroad; it would maximize the railroad's total output. Under such a system, not only would different shippers pay different rates, but the rates would not be proportional to costs. The railroad might make a higher profit on some products than on others.[540]

Taussig's article carried much larger implications than its modest title suggested. It hypothesized that in industries with very high fixed costs and differentiated products, consumer demand rather than producer cost was the principal determinant of market price. A great debate raged for the next thirty years in American and European economics journals over the implica-

537. A.T. HADLEY, RAILROAD TRANSPORTATION, *supra* note 536, at 70-75.

538. Taussig, *supra* note 536. Taussig's work is described more fully in Hovenkamp, *Regulatory Conflict*, *supra* note 3, at 1053-54.

539. Taussig, *supra* note 536, at 438.

540. *Id.* at 439-40.

tions of Taussig's observation.[541]

One important outcome of the debate was a more general theory of decreasing average costs, or "economies of scale." Many of the mechanical and distributional innovations developed in the nineteenth and early twentieth centuries gave their users substantial scale economies. This was true of railroads, mass production, steam and electric power, and oil and gas production and distribution.[542] By the turn of the century, many economists believed that economies of scale explained and "justified" the growth of the trusts. Cornell economist Jeremiah Jenks concluded that "[o]nly great establishments can get the best equipment for cheap production; only such can secure the ablest men . . . ; only such can make the enormous savings in the cost of selling goods which come from doing away with the competitive bidding of traveling men."[543] Charles Whiting Baker argued that the notions of economies of scale and competition were fundamentally in conflict: firms could take advantage of new methods of production and distribution, both of which required large investments, only if they grew large enough to saturate entire markets.[544] Progressive Richard T. Ely acknowledged the pervasiveness and force of economies of scale, but suggested that monopoly pricing was a serious possibility and called for more government control.[545] But Ely was almost a lone voice at the turn of the century.

Except for Ely and one or two others,[546] economists writing on the "trust problem" at the turn of the century expressed remarkable optimism about large corporate growth. When the Sherman Act was passed in 1890, econo-

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541. *See, e.g.,* Chamberlin, *Monopolistic or Imperfect Competition*, 51 Q.J. ECON. 557 (1937) (asserting that the shape of the demand curve—not the nature of increasing returns, as asserted by Robinson, Knight, and others—distinguishes monopolistic and pure competition); Chamberlin, *supra* note 535, at 517-19 (discussing conflict between Taussig and A.C. Pigou over whether discriminatory railroad rates resulted from monopoly or joint cost, and author's 1927-33 efforts to resolve the conflict using a distinction between pure and monopolistic competition); Reinwald, *The Genesis of Chamberlinian Monopolistic Competition Theory*, 9 HIST. POL. ECON. 522, 529-32 (1977) (arguing that Taussig's work and Pigou's work on railway rate differentials "provided an inspiration, but certainly not a foundation" for Chamberlin's work).

542. *See generally* A. CHANDLER, *supra* note 431, at 79-205 (reviewing the technological revolution in transportation, production, and other industry).

543. J.W. JENKS, GREAT FORTUNES; THE WINNING; THE USING 45 (1906); *see* J.W. JENKS, *supra* note 523, chs. 1 & 2 (describing wastes of competition and arguing that monopoly is more efficient in capital-intensive industry).

544. C.W. BAKER, MONOPOLIES AND THE PEOPLE (3d ed. 1899). A similar argument is made in E. VON HALLE, TRUSTS; OR INDUSTRIAL COMBINATIONS AND COALITIONS IN THE UNITED STATES ch. 5 (1895).

545. R. ELY, MONOPOLIES AND TRUSTS ch. 6 (1900).

546. Principally, Henry Carter Adams. *See generally* H.C. Adams, *The Relation of the State to Industrial Action*, 1 PUBLICATIONS AM. ECON. ASS'N. 465 (1887) (rejecting Social Darwinism as a justification for laissez-faire government policy and arguing for limited government regulation of business). Adams suggested that "it was a mistake to suppose that private capital was adequate to meet the needs of a growing country." *Id.* at 468.

mists were generally critical, believing it could rob firms of the economies of scale necessary to spur economic growth and raise the standard of living.[547] The literature also reveals how poorly developed the economic model of competition was, even as late as 1900. For most early writers on trusts, economies of scale counted for almost everything, while the decrease in the number of firms operating in the market mattered little. In the words of George Stigler, turn-of-the-century economists treated "the unregulated corporation as a natural phenomenon."[548] Without much concern about monopoly pricing, writers such as Jenks advocated broad use of cartels, unrestricted joint ventures, and trusts to achieve scale economies. At the same time, Jenks wrote of competition as if it would produce nothing but waste brought about by duplication of effort. For example, he referred to the ability of trusts to eliminate the "expense of competitive selling," as a result of which "the product might be sold for half the price."[549] Within this economic view, the unregulated classical business corporation reigned supreme.

In the second two decades of the twentieth century, however, economists as a group grew concerned about the potential of trusts for monopoly pricing.[550] To be sure, they remained as sensitive as their predecessors to the problems of high capital costs and scale economies. But the phenomenon of the trusts ceased to be a (nearly) unmixed blessing. The new attitude appears prominently in Stanford economist Eliot Jones' 1921 book on trusts.[551] Jones concluded that while giant trusts lowered production costs, they also eliminated wholesome competition and raised prices.[552] Unlike the earlier

547. *See* Hatfield, *The Chicago Trust Conference*, 8 J. POL. ECON. 1, 6 (1899) (noting that a consensus of economists in attendance believed the concentration of industrial wealth in fewer larger corporations to be "the outgrowth of natural industrial evolution"); Hovenkamp, *Antitrust Policy After Chicago*, 84 MICH. L. REV. 213, 220 (1985).

548. Stigler, *Monopoly and Oligopoly by Merger*, 40 AM. ECON. REV., No. 2, PAPERS & PROCEEDINGS 23, 30 (1950).

549. J.W. JENKS, *supra* note 543, at 46.

550. *See, e.g.*, 1 F. TAUSSIG, PRINCIPLES OF ECONOMICS 206 (1911) (monopoly price usually fixed "by a sort of rule of thumb" which, when demand is inelastic, will limit the product supply in order to charge considerably more than the competitive price); I. FISHER, ELEMENTARY PRINCIPLES OF ECONOMICS 329-32 (1912) ("evils" of monopoly pricing include crushing competitors, discriminatory pricing, political corruption and control, and discouraging capital investment); F. FETTER, THE PRINCIPLES OF ECONOMICS 330 (1910) (arguing that effective trusts injure various producers); E. SELIGMAN, PRINCIPLES OF ECONOMICS 235-36, 255-59, 366-70 (1905) (monopoly pricing results in disparate and discriminatory prices, maximum monopoly revenue, and distortion of commercial honesty and fair dealing); R. ELY, *supra* note 543, at 119 (monopoly price generally, but not necessarily, higher than competitive price). Most of these discussions of the monopoly price probably derived from Alfred Marshall's discussion in A. MARSHALL, PRINCIPLES OF ECONOMICS 456-72 (1st ed. 1890). The theory of the monopoly price was much older, and was probably developed first by Cournot. A. COURNOT, RESEARCHES INTO THE MATHEMATICAL PRINCIPLES OF THE THEORY OF WEALTH (N.T. Bacon, trans. 1897). Nevertheless, it did not become prominent in the English classical tradition until Marshall and after.

551. E. JONES, THE TRUST PROBLEM IN THE UNITED STATES (1921).

552. *Id.* ch. 11.

books on trusts, Jones explicitly incorporated the economic theory of monopoly pricing into his analysis of trust behavior.[553] Jones argued that trusts had not achieved the great efficiencies that others had claimed. Moreover, what they gained in productive efficiency they lost in inefficiencies brought about by the lack of incentives produced by competition. "Whereas competition provides a stimulus to the introduction of improved methods, the tendency of monopoly is toward stagnation," Jones concluded.[554]

In 1923, American economist John M. Clark wrote the first book-length study on the law of decreasing costs.[555] He also tried to face head-on the fundamental problem of the "inevitability" of business concentration brought about by economies of scale. Like his predecessors, Clark recognized a contradiction between decreasing costs and perfect competition, particularly if decreasing costs were so substantial that there was room for only a few firms in an industry. Once these firms became established, entry would be difficnlt, and the larger firms in the market would have a substantial cost advantage over the smaller ones. Clark believed that the unregulated market could no longer control the competitive process and that private business was more efficient than government-owned enterprise.[556] But he also believed that widespread control of pricing, wages, working conditions, and consumer contracts would be necessary.[557] He thus came to support federal antitrust laws, as well as other regulatory restraints on the large business corporation.[558]

The debate over economies of scale and decreasing costs substantially undermined the perfect competition model. In a market subject to increasing returns to scale, bigger firms tended to have lower costs than smaller firms. If a "minimum efficient scale" firm had to control, say, 25% of the sales in a market, only four firms could exist in the market. In such a case, one was far less sure that unregulated competition would deliver the optimal mixture of price and quality. Entry into such markets was not easy, as classicism had always presumed. Rather, it was very difficult.

Furthermore, literature of the 1920s viewed firms as exacerbating imperfections in the competitive market by "differentiating" their products from one another in order to minimize direct competition. Even though many firms existed in the market, they behaved more like monopolists than com-

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553. *Id.* at 274-76.

554. *Id.* at 535; *see* Dewing, *A Statistical Test of the Success of Consolidations*, 36 Q. J. ECON. 84 (1921) (concluding after a study of 35 randomly selected trusts that monopoly earnings over time diminished to levels existing at time of initial consolidation).

555. J.M. CLARK, STUDIES IN THE ECONOMICS OF OVERHEAD COSTS (1923).

556. J.M. CLARK, SOCIAL CONTROL OF BUSINESS 419-25 (1926).

557. *Id.* at 449-59.

558. *Id.* at 145, 449-59.

petitors.[559] Prices were based more on customer demand, which differed to the extent that products differed, than on costs.[560] Importantly, however, competition existed on a continuum, with some industries less competitive than others. "The difference between the Standard Oil Company in its prime and the little corner grocery store is quantitative rather than qualitative," Harold Hotelling wrote the year the Great Depression began.[561] "Between the perfect competition and monopoly of theory lie the actual cases."[562]

This great upheaval in competition theory culminated in Chamberlin's *Monopolistic Competition*[563] and Robinson's *Imperfect Competition.*[564] Both sought to destroy the dichotomy between perfect competition and pure monopoly that characterized earlier price theory, by creating a general economic theory of competition in "imperfect" markets, that is, real world markets with economies of scale, entry barriers, and differentiated products. Chamberlin, in particular, described a competitive world that only faintly resembled Adam Smith's invisible hand. Product differentiation was excessive, as firms sought to avoid competing with one another by distinguishing their offerings. Prices were high since each firm based its price more on a monopolistic theory of demand than on its own costs.[565] Output was lower than under perfect competition, since prices were higher. Competitive entry by new firms was difficult, because start-up costs were high, and product differentiation supported by advertising gave established firms large customer-preference advantages over new entrants. The apparent simultaneous failures of the market economy in the Great Depression and of classical economic theory appeared more than coincidental. The time seemed ripe for a more regulatory theory of political economy. Thus, the death of classical price theory occurred; the death of the classical corporation was not far behind.

C. THE BUSINESS CORPORATION IN THE POST-CLASSICAL ERA

In their celebrated 1933 book, *The Modern Corporation and Private Property,* Adolf A. Berle, Jr., and Gardiner C. Means argued that an inherent attribute of the modern business corporation was the separation of ownership and control.[566] Stockholders who collectively represent the greater part of a corporation's shares, generally have little or nothing to say about the real

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559. *See* J. SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS 1047 (1954).
560. *See* Sraffa, *The Laws of Returns Under Competitive Conditions,* 36 ECON. J. 535 (1926).
561. Hotelling, *Stability in Competition,* 39 ECON. J. 41, 44 (1929).
562. *Id.*
563. E. CHAMBERLIN, *supra* note 517.
564. J. ROBINSON, *supra* note 516.
565. For example, under Chamberlin's theory of oligopoly, price approached the monopoly price. E. CHAMBERLIN, *supra* note 517, at 54.
566. Berle, preface to A. BERLE & G. MEANS, *supra* note 518, at vii.

management of the corporation's affairs. Such decisions are in the hands of managers whose ownership interest is generally small. More importantly, the interests of managers and those of stockholders are not always the same. As a result, the corporation may not behave in ways suggested by the theory of competition.

"It is of the essence of revolutions of the more silent sort that they are unrecognized until they are far advanced," Berle wrote.[567] Although they put forth their controversial and important thesis in 1933, the phenonemon they described was prominent by the middle of the nineteenth century, particularly in American railroad corporations. The separation of ownership and control was essential to the modern business corporation's ability to command its resources efficiently.[568] Corporations in competition are constantly trying to reduce costs, a goal often accomplished most effectively by internalizing transactions formerly made in the marketplace.[569] As a result of such vertical integration, more and more corporate activity is taken out of the market, where price and offering are more-or-less given, and placed within the corporation itself, where they are subject to considerable discretion. Furthermore, the corporation's internal business affairs quickly become too complex to be handled by a large group of stockholders who, with the rise of the modern securities market, probably show at best a part-time interest in the corporation's activities. Such responsibility then befalls the corporation's managers.

Berle and Means were not the first to document the separation of ownership and control. It had already been described extensively,[570] primarily from the institutional tradition of Progressive era economics.[571] Much of that literature explicitly related the separation of ownership and control to the trust movement. For example, in 1925 Robert Brookings included a chapter on "The Separation of Ownership and Management" in his *Industrial Ownership: Its Economic and Social Significance*.[572] Brookings pro-

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567. *Id.* at vii.

568. *See* A. CHANDLER, JR., *supra* note 431, at 9-10, 81-87 (suggesting that as businesses grow in size and diversity, managers of the enterprise become separated from ownership).

569. The classic statement of this position is found in Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386 (1937).

570. *See, e.g.*, A. MARSHALL, *supra* note 520, at 641 (noting that "joint stock companies," hampered by friction between shareholders and debenture holders, between ordinary and preferred shareholders, and between all of these and directors, seldom have the enterprise, unity, or quickness of a private business).

571. For notable examples, see T.N. CARVER, THE PRESENT ECONOMIC REVOLUTION IN THE UNITED STATES (1925); Z. RIPLEY, MAIN STREET AND WALL STREET (1927); M. WORMSER, FRANKENSTEIN, INCORPORATED (1931); T. VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES (1923).

572. R. BROOKINGS, INDUSTEIAL OWNERSHIP: ITS ECONOMIC AND SOCIAL SIGNIFICANCE ch. 1 (1925).

posed that the separation of management from ownership "began to be conspicuous at about the turn of the century and was a by-product of what was then regarded as a much more important change, namely, the formation of industrial trusts."[573] Although the attainment of monopoly was the most widely publicized feature of the trust, of far greater significance was "the transfer of the ownership of a substantial portion of the capital of industrial corporations to a wide investing and speculative public."[574] The corporation's owners no longer took an active role in the affairs of the corporation.[575] As a result, Brookings argued, management no longer felt the immediate consequences of the corporation's economic decisions.[576] This justified more intensive government regulation of management's relationship with owners, labor, and the public in general.

The rise of big business and the growth of industrial concentration were likewise the premises of Berle's and Means' book.[577] Part I of *The Modern Corporation and Private Property* was devoted substantially to corporate growth. Because of the widespread phenomenon of interlocking boards of directors- -one person serving as director of more than one company—about 2,000 people served as directors of the 200 largest corporations.[578] This economic power controlled by a "few persons" is "a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, [and] bring ruin to one community and prosperity to another," they concluded. "The organizations which they control have passed far beyond the realm of private enterprise—they have become more nearly institutions."[579] Berle and Means then went on to argue that because these directors and corporate managers lacked substantial ownership interests in their firms, they also lacked the proper incentives to make their management efficient and in the public interest.

The explicitly economic nature of this premise notwithstanding, one is struck by the general absence of theoretical economics in *The Modern Corporation and Private Property.* Berle selected Means as a co-author principally because Means was an economist.[580] But Means' chief contribution was several chapters of statistics showing how corporations had grown, how concentrated American industry had become, and how share ownership was widely

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573. *Id.* at 2.

574. *Id.* at 4; *see* Navin & Sears, *The Rise of a Market for Industrial Securities, 1887-1902,* 29 BUS. HIST. REV. 105, 113-15 (1955) (describing the rise of an enormous speculative market for trust certificates).

575. R. BROOKINGS, *supra* note 572, at 10.

576. *Id.* at 11-12.

577. A. BERLE & G. MEANS, *supra* note 518.

578. *Id.* at 46.

579. *Id.*.

580. *Id.* at v.

dispersed.[581] Except for an occasional citation to Adam Smith and one to Thorstein Veblen's *Absentee Ownership,*[582] there was no discussion of economic literature. One brief discussion in book IV, chapter 3 suggested that the theory of competition as envisioned by Adam Smith which assumed small business units having little fixed capital and overhead costs, no longer applied in modern business.[583] But they said nothing about alternative economic mechanisms of analyzing firm behavior. This was a book written for lawyers. Likewise, most economists ignored Berle and Means. For example, in his pathbreaking article on the nature of the firm five years later, Ronald Coase never cited Berle's and Means' work and virtually ignored the "legal" literature on the structure of the business firm.[584] 1932 was still part of the great age of specialization, and citation to works in another discipline was considered more a sign of weakness than of strength.[585]

Berle's and Means' study contributed greatly to the breakdown of the classical corporation in legal theory, for it appeared to undermine perhaps the most essential premise regarding the classical corporation: that the "invisible hand" would turn each firm's desire to maximize its own profit into a grand, market-based scheme that would maximize the wealth of society. Under Berle's and Means' scheme, the awesome possibility arose that corporations were not profit-maximizers. Shareholders, who had the motive to maximize profits, had "surrendered all disposition . . . to those in control of the enterprise."[586] Managers, who had the power to make the firm profitable, received salaries which were often set without obvious relation to profit, thus depriving corporate managers of the classical profit motive.[587]

Berle and Means argued that competition could no longer be trusted to gnarantee efficient corporate behavior. They assumed, although without citation, the validity of most of the arguments in the new economics literature which attacked the classical concept of competition. For example, they argued that in an age of high corporate concentration, competition either be-

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581. *Id.* chs. 1-4.

582. T. VEBLEN, *supra* note 571.

583. *Id.* at 350-51. This discussion suggests that Berle & Means were thinking of J.M. CLARK, STUDIES IN THE ECONOMICS OF OVERHEAD COSTS (1923), which argued that high fixed costs undermined the classical competition model. But Clark's book was not cited.

584. Coase, *supra* note 569, at 403-05 (citing only one legal source, Batt on *Law of Master and Servant,* to show that legal retlationship of employer and employee was consistent with the economic theory of the firm).

585. For other use of Berle & Means by economists, see Stigler & Friedland, *The Literature of Economics: the Case of Berle and Means,* 226 J.L. & ECON. 337, 344 (1983).

586. A. BERLE & G. MEANS, *supra* note 518, at 9.

587. *Id.* at 333; *see id.* at 340-44 (discussing the "traditional logic of profits," which suggests that profits in excess of those necessary to satisfy security holders should go to management). *But see* Stigler & Friedland, *supra* note 585, at 246-58 (suggesting that management satisfies its own desires first, treating stockholders like creditors).

came "cut-throat and destructive or so inactive as to make monopoly or duopoly conditions prevail."[588] Competition as envisioned by the classicists was no longer possible as an "effective regulator of industry and of profits."[589] They concluded that since the corporation was no longer being run to serve the interests of its highly diffuse shareholders, and directors lacked the motive to run corporations in the public interest, the running of the corporation had to be subjected to "the paramount interest of the community."[590] These concerns legitimately included "fair wages, security to employees, reasonable service to their public, and stabilization of business."[591] That view, of course, was anathema to the classical theory of the corproation, which had sought to privatize the ordinary corporation as much as possible, treating only public service corporations differently.

Influence is hard to measure. The Great Depression undoubtedly did far more than any book to undermine Americans' faith in the classical market system. Nevertheless Berle and Means contributed much to the rhetoric of government policy toward business in the New Deal and later. *Time* magazine called *The Modern Corporation and Private Property* "the economic Bible of the Roosevelt administration."[592] The bias against corporate size expressed by Berle and Means surfaced in government policy in a number of ways, particularly in the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the Securities Exchange Commission.[593]

The bias also appeared in the developing government hostility toward vertical integration by business firms. Although separation of ownership and control is related to large corporate size, it is much more a function of the number of activities in which a firm engages than of the size of the individual transactions. As a result, it is reflected much more by vertical growth than by mere large horizontal size. A very large firm that does nothing but purchase raw materials, manufacture mousetraps by the millions, and sell them f.o.b. to any buyer who comes along, may have affairs not appreciably more complex than those of a much smaller firm that makes them by the dozen. Corporate activity becomes much more complex, however, when the corporation enters distribution, retailing, transportation, advertising, and perhaps production of raw materials. As a result, the degree of vertical integration, rather than absolute size, is the largest contibutor to separation of

588. A. BERLE & G. MEANS, *supra* note 518, at 351.
589. *Id.* at 356.
590. *Id.*.
591. *Id.*.
592. TIME, April 24, 1933, at 14.
593. On Berle's participation in the move for broader securities regulation, see M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL (1970); J. SELIGMAN, THE TRANSFORMATION OF WALL STREET (1982).

ownership and control. For example, the "visible hand" in Alfred Chandler's important history of American business[594] is not mere corporate size, but rather the substitution of management decisions for market decisions. When the firm integrated vertically, it used the market less and internal management more.

Classical political economy never expressed much concern about vertical integration, and never viewed it as a problem of monopoly.[595] Traditionally, legislative policy toward incorporation had expressed more hostility toward vertical integration, though this was more a result of fear of the inherently monopolistic nature of the preclassical corporate charter than of vertical integration itself.[596] Since a charter was a special privilege from the state, its scope was strictly construed. A privilege to engage in one kind of enterprise did not imply a privilege to engage in another. Although corporate charters given to manufacturers seldom limited the amounts they could produce, the charters rigorously limited the activites in which the corporation could engage. A firm authorized to engage in one activity engaged in another at its peril, even if the two were closely related. Hundreds of ultra vires and quo warranto decisions against corporations were for activities that today would be regarded by many as nothing more than harmless vertical integration.[597]

To the extent that vertical integration was an inherent attribute of the classical business corporation, state policy eventually made room for it. Legislatively, charters with broad business purpose clauses became common by the 1880s, and eventually states began passing general incorporation acts au-

594. A. CHANDLER, *supra* note 431.

595. In fact, many modern neoclassicists believe that, although monopoly of a single market is socially harmful, vertical integration is virtually always harmless and generally socially beneficial. It does not inherently increase the firm's market share of any product or service, but it does reduce the firm's costs of doing business, making it more efficient. *See generally* H. HOVENKAMP, ECONOMICS AND FEDERAL ANTITRUST LAW ch. 7 (1985); Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157 (1954).

596. The common law actually encouraged vertical integration by its hostility toward middlemen. For example, the law of regrating forbade the purchase and resale of foodstuffs. W. LETWIN, LAW AND ECONOMIC POLICY IN AMERICA: THE EVOLUTION OF THE SHERMAN ANTITRUST ACT 34, 38 (1965).

597. Courts routinely condemned as ultra vires the move of a corporation engaged in one enterprise into another field. *See* Thomas v. Railroad Co., 101 U.S. 71, 86-87 (1879) (condemning move of railroads into the sale or leasing of real property); Pearce v. Madison & Indiana R.R., 62 U.S. (21 How.) 441, 445 (1858) (condemning move of railroad into steamship transportation); Chewacla Lime Works v. Dismukes, 87 Ala. 344, 347 (1889) (condemning mining company's opening of company store); Cherokee Iron Co. v. Jones, 52 Ga. 276, 280 (1874) (condemning the move of an iron manufacturer into milling); Davis v. Old Colony R.R., 131 Mass. 258, 275-76 (1879) (condemning move of railroad into tourist business); Hoagland v. Hannibal & St. Joseph R.R., 39 Mo. 451, 458 (1867) (condemning move of railroad into steamship transportation); Northwestern Union Packet Co. v. Shaw, 37 Wis. 655, 660, 19 Am. Rep. 781, 783 (1875) (condemning barge company's moving into grain business).

thorizing corporations to engage in any lawful business.[598] Judicially, the doctrine of ultra vires was gradually relaxed so as to permit corporations to engage in activities related to those indentified in their charters.

But in the wake of the theories of monopolistic competition and Berle's and Means' study, a new theory of industrial organization emerged that renewed the concern about vertical integration. The worries were twofold. The first was that large firms could entrench or solidify their monopoly power by vertical integration. Economist Arthur R. Burns' massive 1936 study of competition in American industry[599] relied on Berle and Means and the new literature on competition to conclude that, although vertical integration might produce some cost savings, on the whole it "diminishes the effectiveness of the market as a stimulus to the improvement of methods of production"[600] and could enable a firm which gained control of earlier stages of a market to "impose a levy upon the output of its less integrated rivals."[601]

The second concern was that vertical integration might be pursued by corporate management in spite of the fact that it was inefficient, unprofitable and harmful to society as a whole. Managers might do this to enhance their own power by reaching as far as they could in every direction, by maximizing output rather than profits, and perhaps by making the affairs of the corporation so complex that the average stockholder could not appreciate what was going on. Berle and Means argued that, as a result of widespread vertical integration, the corporation's costs had become "indeterminate";[602] it had its fingers in so many pies that it could not identify the costs of producing a particular product.

Under this theory the corporation needed to be saved from its own managers, who were undermining its ability to maximize its profits. This observation of Berle and Means was manifested in the 1930s and 1940s literature on the theory of the firm, which developed a consensus that the long-run average cost curve of the firm is U-shaped rather than continually downward sloping; in short, firms could become too big, causing their costs to rise.[603] But if, as Berle and Means suggested, costs became indeterminate when firms grew very large, corporate managers would not know when their companies had become inefficient dinosaurs.

The situation seemed to beg for legal regulation of firm size. The enor-

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598. *See, e.g.* An Act Concerning Corporations, ch. 185, 1896 N.J. LAWS 277, 279 (1896) (allowing corporations to engage in "any lawful business or purpose whatsoever").

599. A. BURNS, THE DECLINE OF COMPETITION (1936).

600. *Id.* at 431.

601. *Id.* at 441.

602. A. BERLE & G. MEANS, *supra* note 518, at 350-51.

603. *See generally* Chamberlin, *Proportionality, Divisibility and Economies of Scale*, 62 Q. J. ECON. 229 (1948); E.A.G. ROBINSON, THE STRUCTURE OF COMPETITIVE INDUSTRY 44 (rev. ed. 1958). The theory had been previously described in 1926. J.M. CLARK, *supra* note 555, at 131.

mous potential danger explains the great increase in concern about vertical integration and mergers in the 1930s and 1940s, first in the reports of the Federal Trade Commission[604] and the New Deal's Temporary National Economic Committee,[605] and later in the case law.[606] The eventual result was passage of the Celler-Kefauver Act in 1950,[607] which greatly strengthened the merger provision in section 7 of the Clayton Act and made it explicitly applicable to vertical mergers.[608]

IX. CONCLUSION

By the end of the New Deal, little was left of the classical corporation. Its internal dealings with shareholders and its debtor-creditor relations were substantially regulated by the federal securities acts. Its labor relations were regulated by the new federal labor laws. Its relations in the general market with consumers and suppliers became increasingly regulated by the antitrust laws and the Federal Trade Commission, which tried to impose on it a duty to engage in only "fair" competition.[609] In 1938 the Federal Trade Commission Act was amended to establish that the FTC had jurisdiction over a firm's "unfair or deceptive act or practice," whether or not the antitrust laws were violated.[610] For the emerging category of utilities and "public service" companies, regulation was even more complete, including restrictions on entry and price controls.

But the postclassical corporation was not much like the preclassical corporation. The distinctiveness of the corporate form of private enterprise was gone, perhaps forever. Shareholders never regained the control they once

604. For a discussion of cases arising under section 7 of the Clayton Act, see F.T.C., ANNUAL REPORTS at the following pages: the 1928 ANNUAL REPORT at 19; for 1929, at 59; for 1930, at 50-51; for 1935, at 16, 48; for 1936, at 48; for 1937, at 15; for 1938, at 11, 19, 29; for 1940 at 12-13.

605. *TNEC, Final Report and Recommendations* 38-40, S. Doc. No. 35, 77th Cong., 1st Sess. (1941).

606. *E.g.*, United States v. Columbia Co., 334 U.S. 495 (1948); United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948); United States v. Yellow Cab Co., 332 U.S. 218 (1947); United States v. New York Great Atlantic & Pacific Tea Co., 173 F.2d 79 (7th Cir. 1949); *see also* Hale, *Vertical Integration*, 49 COLUM. L. REV. 921 (1949) (discussing impact of antitrust laws on vertical integration).

607. 15 U.S.C. § 18 (1986) (amending Clayton Act ch. 323, § 7, 38 Stat. 730, 731-32 (1914). On the legislative history, see Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 233-38 (1960); Hovenkamp, *Derek Bok and the Merger of Law and Economics*, — J.L. REFORM — (1988) (forthcoming).

608. *See* Brown Shoe Co. v. United States, 370 U.S. 294, 314-23 (1962) (examining the legislative history for the section 7 amendment and noting that Congress attempted to make plain that section 7 applied also to vertical mergers).

609. *See* Federal Trade Commission v. F.R. Keppel & Bros., 291 U.S. 304 (1934) (holding that FTC had jurisdiction to reach unfair business practices not condemned under the antitrust laws). Act of Mar. 21, 1938, 15 U.S.C. § 52 (1986).

610. Wheeler-Lea Amendment, Act of Mar. 21, 1938, ch. 49, § 4, 52 Stat. 114 (1938) (codified as amended at 15 U.S.C. § 52 (1986)).

had. Limited liability remained the rule, and corporations remained "persons" for the purposes of constitutional law. But after the 1920s, the corporation, in common with all forms of business organization, entered a new era in which it could experience once again the benefits and burdens of governmental regulation. The invisible hand of the marketplace had been struck aside by the very visible hand of the state.